



National Audit Office

**REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL**

**HC 546
SESSION 2008–2009
16 OCTOBER 2009**

Government cash management

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Amyas Morse

Comptroller and
Auditor General

National Audit Office

22 September 2009

The aim of good cash management is to have the right amount of cash available at the right time, and to do this cost effectively. Making this cash available and storing any surplus cash has both risk and cost implications for the taxpayer.

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The National Audit Office study team
consisted of:

Matthew Cain, Daniel Fairhead,
Sascha Kiess, Gabrielle Nutt and
Alison Terry, under the direction of
Keith Davis

This report can be found on the
National Audit Office website at
www.nao.org.uk

For further information about the
National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

Summary

1 The aim of good cash management is to have the right amount of cash available at the right time, and to do this cost effectively. Making this cash available and storing any surplus cash has both risk and cost implications for the taxpayer. In light of the government's tighter fiscal position, good cash flow management is becoming even more important.

2 Central government departments and their sponsored bodies play a critical role in minimising the risks and costs associated with cash management. In 2008-09, the 14 departments¹ covered by this report were responsible for spending and distributing over £400 billion in the provision of public services, social welfare, and public goods and assets.

3 Departments keep money at the Exchequer² until they are ready to make payments. These payments represent a significant proportion of the United Kingdom's banking transactions, with state benefits alone accounting for over 16 per cent of the 6.8 billion banking transactions made in 2007³. While delaying payments can help to keep money within the Exchequer and minimise borrowing, the government also has a responsibility to pay its suppliers on time. In the past its target was to pay suppliers within 30 days of receiving a valid invoice. The recent announcement of measures to support business means government should be paying suppliers within 10 days, and that cash will leave the Exchequer earlier.

4 To deliver its objectives the government uses a wide range of other organisations. Hence devolved administrations, local authorities and health trusts as well as private, voluntary and community bodies also receive central government funding. Excluding Local Authorities, the majority of government funding is held at the Exchequer. It is government policy to maximise the amount of money at the Exchequer, as it helps to directly offset government borrowing or generate interest if loaned out, although holding some cash in commercial accounts is always likely to be required.

¹ These include the large central government spending departments. A complete list can be seen in Appendix One.

² We refer in this report to the Exchequer as the set of bodies that manage government funds. They comprise the Treasury, the Debt Management Office, and the Office of HM Paymaster General, which is now part of the Government Banking Service (see Appendix Four).

³ UK Payment Statistics 2008 and UK Payment Markets 2008, published by APACS and the Payments Council.

5 A recent National Audit Office report found that only half of departmental finance teams rated themselves as strong at cash management and 34 per cent of departments did not provide any cash flow information to their Boards⁴.

6 Against this background, we have identified three key factors in managing government cash efficiently and effectively:

- Keeping as much money at the Exchequer as possible. This cash minimises the amount of government borrowing on any given day, reducing interest costs and improving the fiscal balance. By keeping cash centrally, the government also knows how much cash it is holding, and where it is. This allows it to better manage the associated risks of holding cash, and take better decisions about the public finances as a whole, particularly regarding cash shortfalls and surpluses.
- Accurately predicting cash flows in and out of the Exchequer. Improved precision allows the Debt Management Office to minimise the number of last minute transactions on a given day, as it is generally more expensive to carry out or to reverse a lending or borrowing transaction late in the day.
- Minimising the costs of tendering for and using banking services.

7 Our examination focuses on:

- whether cash management processes make the right amount of money available at the right time in a cost-effective way (Part One); and
- whether the costs of banking are minimised and risks associated with cash are being managed appropriately (Part Two).

Key findings

8 On cash flow management:

- **Central government departments and their sponsored bodies hold more money in commercial bank accounts than is necessary.** As at 31 March 2008, the Treasury estimated that public bodies are holding £4 billion in commercial accounts. This is partly because organisations use commercial banks when they could keep their money at the Exchequer, and partly because bodies draw down money from their sponsor departments before it is needed. Although this represents less than four days of central government spending, our sample of 16 sponsored bodies held on average 50 per cent higher cash balances throughout 2008-09 compared to 31 March 2009. While it is not possible to extrapolate from this small sample, it suggests that on average more than £4 billion was being held in commercial accounts throughout the year. By minimising these balances, there is an opportunity to reduce government borrowing, manage the risks of holding cash more effectively, and have better information about when to borrow or invest.

⁴ C&AG's report: *Managing financial resources to deliver public services*, HC 123, Session 2007-08.

- We estimate that £275 million a day was held outside the Exchequer in 2008-09 by the 16 sponsored bodies in our survey.** If this cash had been in Exchequer accounts, it potentially could have saved £9.1 million in interest on government debt throughout the year, compared to the £7.1 million in interest on their commercial bank balances. However, in some cases changing banking provider would require a cultural change, including some independent bodies overcoming their resistance to banking with a government institution.
- Departments have generally become more accurate in forecasting their cash flow with their aggregated monthly net expenditure varying from forecast by an average of £1 billion, or three per cent of average monthly expenditure.** Some departments recognise that they do not do enough to collect information from business units, budget holders and sponsored bodies to enable them to forecast their cash flow accurately. Instead they rely on profiling budgets equally across the year, adjusted for past trends. Departments that have improved the communication and interaction between their forecasting and payment functions and their sponsored bodies are better able to manage their expenditure and provide more accurate forecast information to the Treasury.
- Inaccurate forecasting can lead to losses for the taxpayer.** Depending on market conditions, the government may suffer a loss from poor forecasting decisions, as the market rates change over time, and because of a cost known as the 'bid offer spread'. This bid offer spread is the difference between the interest rate for a lender and a borrower, and the Debt Management Office estimates that this generally varies between 0.1 and 0.15 per cent⁵. In 2008-09 the government as a whole over- or under-forecast its cash requirements by an average of £63 million a day, or four per cent of net spending, which may have increased costs by £95,000 for the year. There are other important effects of poor cash flow forecasting of which the costs are less easily quantifiable, but are likely to be significant. Poor forecasting can lead to sustained increased borrowing, as the Debt Management Office needs to hold higher cash balances to cover unexpected late cash flows. With accurate long-term forecasts the Debt Management Office can make better use of opportunities in the market to even out future cash flows by borrowing and lending money at the best rates. It would also reduce the risk of making high value, last minute transactions at poor rates.
- Central government departments generally produced less accurate forecasts in the final month of the financial year.** Over the last four years, March was the only month in which the variance against forecast was always greater than three per cent. March is also the month in which government spending is generally at its highest.

5 This is an annual rate, and so the true cost of the bid offer spread on a given day is equal to the bid offer spread divided by 365.

- **The Treasury incentivises central government departments to improve the accuracy of forecasting their cash flows in and out of the Exchequer, but not to maximise the amount of money they hold in these accounts, which is of greater benefit to the taxpayer.** The Treasury publishes guidance that requires public bodies to keep as much money as possible at the Exchequer, but the incentive mechanisms, which use transparent performance reporting and peer pressure, concentrate attention on forecasting. Any cash savings arising as a result of either higher balances at the Exchequer or improved forecasting fall to the government as a whole, not to individual departments or their sponsored bodies.
 - **In our sample of sponsored bodies, only the Boards of Trading Funds⁶ receive reports on their organisations' cash balances and interest earnings on a regular basis.** Staff felt that senior management engagement helped focus the attention of the entire organisation on good cash management.
- 9** On prompt payment:
- **There is an inconsistent understanding of, and variable performance against, the government's target to pay suppliers within 10 days.** In March 2009, 90 per cent of invoices in the organisations we surveyed were paid within 10 days. Electronic procurement and invoicing of goods and services were generally seen by these organisations as an effective way to improve the speed of payment.
- 10** On banking services:
- **It is not mandatory for public bodies other than central government departments to use Government Banking Service accounts and hold money at the Exchequer, although the Treasury's guidance states that balances in commercial accounts should be minimised.** Each public sector body that uses commercial banking services as well as, or instead of, the Government Banking Service account, competitively procures its own, which incurs additional time and costs, and leads to large variations in the transaction fees paid and interest rates earned. In 2008-09 public bodies paid £7.5 million in fees for their Government Banking Service account and banking services such as BACS⁷, CHAPS⁸ and Payable Order⁹ transactions. In the same year, the organisations in our survey paid just over £2 million in fees and transaction charges to commercial banks. When procuring specialised banking services, such as for secure cash transit and foreign exchange, public bodies are not working together enough.

⁶ Trading funds are public sector organisations that have been set up as a means of financing the revenue-generating operations of a government department.

⁷ Bankers Automated Clearing Service (BACS) is a not-for-profit industry body which allows funds to be transferred electronically between banks. In general, a BACS payment initiated on day one of a payment cycle will arrive in the recipient's bank account two days later, on day three.

⁸ Clearing House Automated Payment System (CHAPS) is a same-day, inter-bank electronic credit transfer service between banks in the United Kingdom.

⁹ The cheque service used by the Office of HM Paymaster General.

- **Use of BACS is generally more economic and efficient.** It is cheaper than other electronic payment methods such as CHAPS, and both cheaper and more secure than using cheques. Poor planning, in conjunction with the Treasury's incentive mechanism around accurate forecasting, means that some organisations feel obliged to make some urgent payments by CHAPS, which take less than one day to clear as opposed to BACS payments which take up to three days. Some organisations also make many of their payments by cheque, partly because some payees prefer them, and partly to avoid the administrative burden of entering payees' details into the electronic payments systems.
- **Credit risk was a concern to over a third of our sample of sponsored bodies.** Many departments keep money in more than one of the United Kingdom regulated clearing banks, and there is no government-wide dependency on any one bank. Although public bodies are aware of, and monitor, credit risk, investigations of financial exposure by the 14 departments we surveyed found that 11 of their bodies had a total of £96 million invested in Icelandic accounts.

Conclusion on value for money

11 Central government as a whole is not managing its cash in a way that maximises value for money, largely because it could hold more cash in the Exchequer. Money that leaves the Exchequer needs to be raised by the government at a cost that is close to the Bank of England bank rate, which ranged from five per cent to 0.5 per cent in 2008-09. In some cases this money is held in commercial bank accounts, earning interest, before it is used to make payments. However, for the bodies in our sample the average interest rate earned was 0.7 per cent below the bank rate. Using this rate, the £4 billion held in commercial bank accounts at 31 March 2008 would have cost the government £28 million in higher interest payments over the year. Although the current unusually low interest rates would reduce the potential savings, most of our sample of sponsored bodies held on average 50 per cent higher cash balances throughout 2008-09 compared to 31 March 2009. While it is not possible to extrapolate from this small sample, it suggests the £4 billion is an underestimate. There are also broader benefits from using the central expertise of the Debt Management Office to manage cash balances and the associated risk.

12 Some organisations are ready to move over to the Exchequer as their banking provider almost immediately. Others, especially those that have complicated banking arrangements or want to maintain their independence from government, would incur considerable one-off costs or require a significant cultural change. These factors would apply to any change of banking provider, and the costs may include changing internal processes to align with those of the new provider, adjusting computer software, and ensuring all customers know and use the new bank account details.

Recommendations

13 The following recommendations for departments, their sponsored public sector bodies and the centre of government identify improvements in government cash management that can be achieved primarily by changing working methods, sharing information, or adjusting organisation structures, without the need to incur significant implementation costs.

14 The highest priority recommendations that would deliver the greatest benefits, both financially and non-financially, are recommendations 1) and 6), on banking with the Government Banking Service and refocusing the Treasury's incentive mechanisms.

Recommendations for departments and public sector bodies.

Central government departments and their sponsored bodies hold more money in commercial bank accounts than they need

- 1** Departments and their sponsored bodies should have their main account with the Government Banking Service, so that unspent money is kept at the Exchequer. This is one of the most important elements of good cash management in government, as it not only reduces government borrowing, but minimises risks and allows the government to plan and manage its cash flow more cost-effectively. Organisations should only have commercial bank accounts where they have agreed with the Treasury that the Government Banking Service cannot satisfy a particular business need.
- 2** Departments need to improve their links with sponsored bodies and collect more accurate information on when they use their cash. Based on the data, they should amend payment cycles to sponsored bodies with commercial bank accounts so that the bodies receive money when they need it, and not before. This amendment may be for more frequent payments, or making the monthly payments closer to the date when significant liabilities, such as payroll, need to be met.

Monthly net expenditure for the 14 departments in our survey varies from forecast by an average of £1 billion

- 3** Public bodies need to gather information from business units to forecast individual monthly expenditure. To do this effectively they need to structure themselves to facilitate continuous dialogue between those staff responsible for forecasting cash requirements, and those making payments. They also need to emphasise to budget holders responsible for approving large payments and claiming receipts in their own organisation, as well as any sponsored bodies, the importance of accurate forecasting and communicating any changes to forecasts as soon as possible to the cash managers.

Few Boards routinely receive information about their organisation's cash position

- 4 With the tighter fiscal position, Boards should have greater oversight of information on cash flow so they better understand the pattern of spend as well as total spend, and can address any potential risks. Central finance teams should develop more informative reports, which ought to include movements in the main current bank accounts and comments on variances. Where there is an operational need to have commercial accounts, Boards should ensure that cash balances are invested in interest earning accounts, while having due regard for credit risk. They should also receive reports on the proportion of their cash which earns interest, the rates earned, and a credit assessment of the institution with which their funds are held.

Organisations are using less cost-effective methods of payment, such as cheques and CHAPS, because of poor planning

- 5 Organisations should manage their payments in a way that allows them to use the most cost-effective methods, and develop strategies for limiting the use of expensive paper-handling.

Appendix Three sets out some more detailed principles of good cash management.

Recommendations for the centre of government.

The current incentives for cash management focus on accurate forecasting, but this does not address money that is unnecessarily kept outside the Exchequer

- 6 The Treasury needs to extend its incentives to encourage public bodies to keep more money in accounts at the Exchequer, for example, by making bodies' performance in this regard more transparent. It could also, together with the Government Banking Service, take a more active approach to achieving compliance with its guidance on minimising commercial balances. Any of these steps would need to be taken in a way that minimises unintended behaviours, and would also incur some limited additional staff cost. However, new mechanisms are critical in shifting the focus away from just accurate forecasting. The most cost-effective system would be for all public bodies to bank with the Exchequer and manage their cash in accordance with the guidance without the need for incentives.

Good practice in forecasting cash flow and managing payments exists, but is not systematically adopted across government

- 7 The Treasury is already working with departments to improve their performance, but should focus more on those departments with the greatest scope to improve, based on current performance and the context in which they operate. In light of the tighter fiscal position, it should work with all departments to help them identify how they can improve their forecasting accuracy, particularly at the end of the financial year, without compromising the policy of minimising cash balances held in commercial accounts.

By undertaking their own tendering processes for commercial banking and cash transit services, public bodies are unlikely to all be getting the best value for government as a whole

- 8 Where there is a value for money case for using a commercial provider for standard banking services, public bodies should seek approval from the Treasury. When procuring specialised banking services, organisations should first check whether the new Government Banking Service is able to provide them. If not, they should work with the Government Banking Service during the specification and tendering process, as it can coordinate knowledge sharing across the wider public sector.

Part One

Cash flow management

1.1 The government needs to have the right amount of cash available at the right time to deliver its objectives. Good cash flow management does this cost effectively. An overview of the United Kingdom's cash management system can be found in Appendix Four. This Part of the report examines how well government bodies manage their cash with respect to:

- accurately forecasting cash flow, so that shortfalls and surpluses can be anticipated;
- keeping as much money at the Exchequer as possible, to offset government borrowing;
- managing payments and receipts in a timely and cost-effective way; and
- having in place the appropriate governance arrangements to manage the processes.

Accurately forecasting cash flow

The challenge of accurate forecasting

1.2 All departments hold accounts with the Government Banking Service, referred to in this report as “Exchequer” accounts. They forecast all their payments in to and out of these accounts. Payments that leave the Exchequer are significant because they involve actual cash transactions. The Debt Management Office builds up a pool of cash through a combination of tax receipts and borrowing, and makes sure this money is available to meet each day's payments.

1.3 Those departments with sponsored bodies that also have Exchequer accounts need to forecast the daily payments that their sponsored bodies intend to make as well as their own. For example, the forecast prepared by the Ministry of Justice includes the cash payments and receipts of the Scottish and Welsh Assemblies, which make up around 80 per cent of its forecasts, but over which it has no control. Departments that pay grants to their sponsored bodies directly into commercial banks only need to forecast those outflows, not the individual payments the sponsored bodies expect to make. This system makes it easier to forecast payments accurately, but goes against the Treasury's policy of keeping money at the Exchequer for as long as possible. Where the bodies in the health and education sectors are independent from central government, regulators and other public sector organisations may take on the role of monitoring cash flow performance (Appendix Six).

Current performance

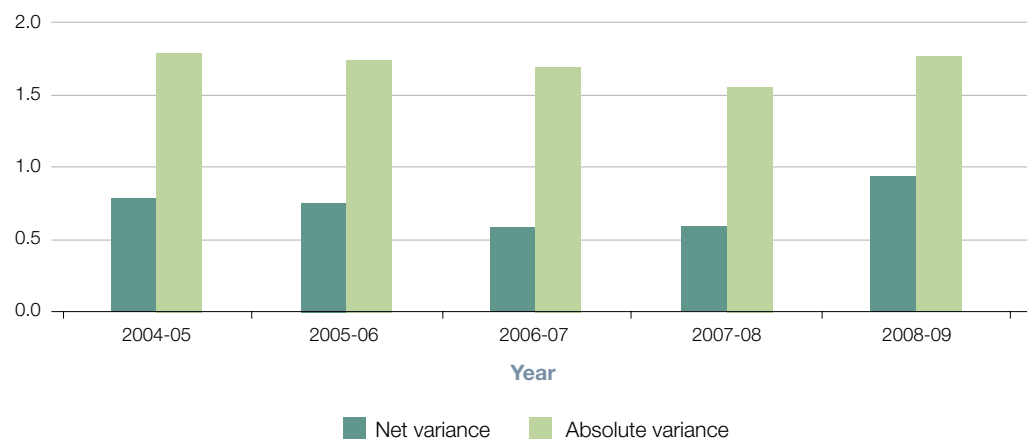
1.4 In 2008-09 six of the 14 large departments achieved the Treasury's target for forecast accuracy, with an average monthly variance of less than five per cent over the year. There was a wide variation in the performance, as the top six performing departments had an average forecast variance of just under three per cent, while the others averaged nearly 12 per cent (Appendix Five).

1.5 Departments collectively improved their forecasting accuracy between 2004-05 and 2007-08, but this deteriorated in 2008-09 (**Figure 1**). Although individually departments forecast more accurately in 2008-09 than in 2007-08, the collective deterioration was because many departments over or under forecast their cash flow the same way in the same month, leading to a higher net inaccuracy. For example, in April 2008, Communities and Local Government and the Ministry of Defence both under forecast their cash requirements by over £500 million. Overall, aggregated monthly net expenditure for the 14 departments in our survey varied from forecast by an average of £1 billion.

Figure 1

Average monthly variances in large government department cash flow forecasts

Variance from forecast (£bn)



Source: National Audit Office analysis of HM Treasury data

NOTE

This graph includes forecast and outturn data for all the 14 large departments in our survey. The absolute variances are the absolute monthly variances for each department, summed and then averaged for the year. The net variances are the combined forecast and outturn data for all departments each month, which is then averaged over the year. The absolute variances are higher, as over and under forecasting by different departments acts to cancel each other out and produce a lower net variance. Only data for 10 months of each year have been used, discarding the results for the best and worst months, to minimise any distortion caused by irregular events.

Factors affecting performance

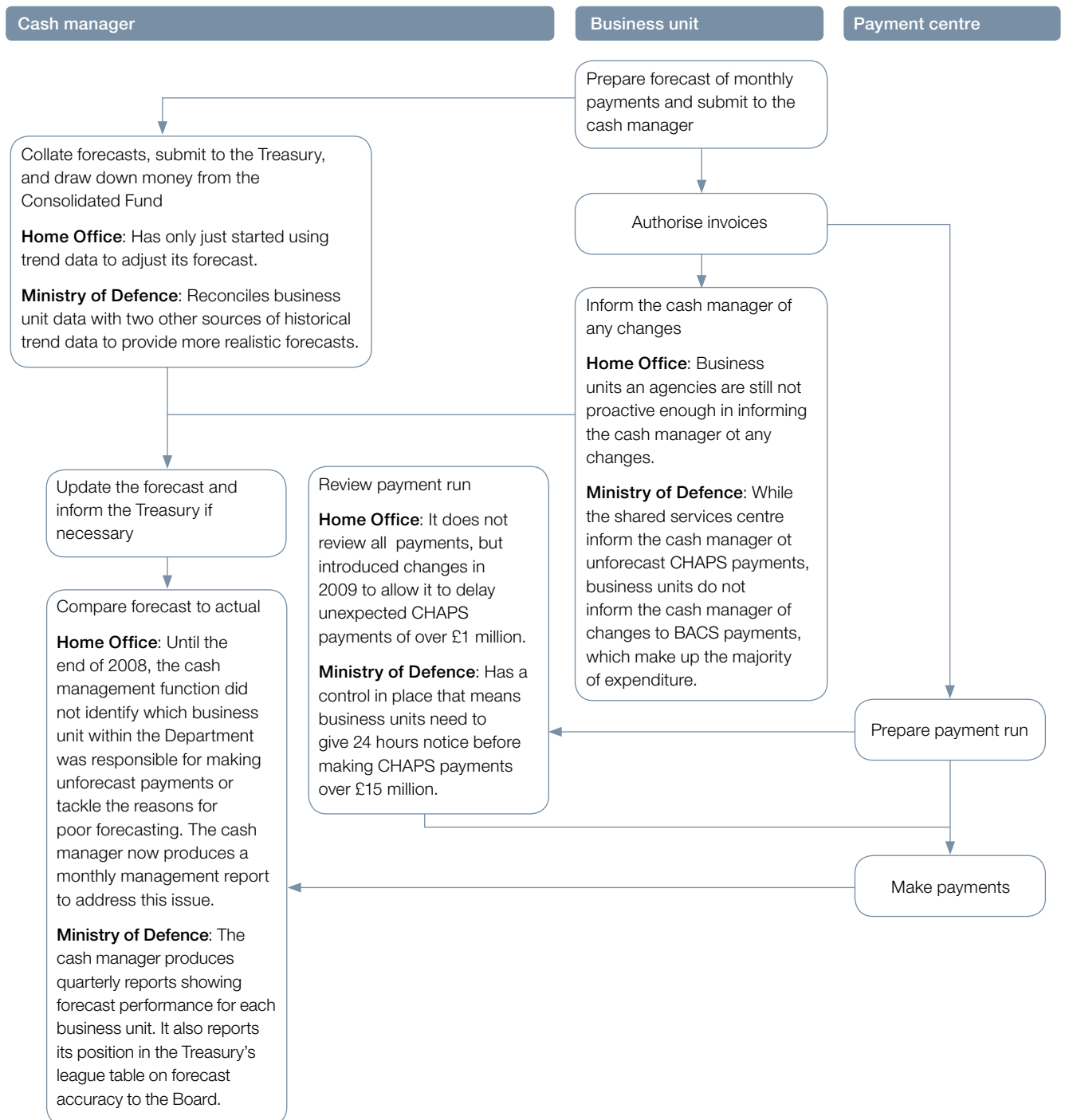
1.6 Some departments, due to the nature of their cash spending, may find it easier to forecast accurately than others. Of the 14 departments in our survey, the Department for Culture, Media and Sport and the Department for Work and Pensions produced the most accurate forecasts throughout 2007-08 and 2008-09, while the Department for Environment, Food and Rural Affairs and the Department for International Development were among the least accurate. But this may partly be due to the nature of their cash spending, as generally the more that departments' expenditure fluctuates, and the more of their expenditure is not made in the form of grants, the lower their forecast accuracy.

1.7 In 2007-08, for example, the Department for Culture, Media and Sport had relatively even month to month expenditure, and grants to its sponsored bodies represented 98 per cent of its expenditure, which may partly explain why it achieved the highest forecast accuracy. By contrast, the Department for Environment, Food and Rural Affairs' expenditure fluctuated considerably, and only 25 per cent of its expenditure was on grants, with the rest being a combination of administrative expenditure as well as bill payments and receipts on the part of its Executive Agencies. This complexity may explain why it was one of the least accurate forecasters.

1.8 While the nature of spending is important, systems and processes also affect performance. Departments in similar circumstances, such as the Home Office and the Ministry of Defence, which have fairly autonomous divisions or bodies separate from headquarters, follow similar forecasting and payment processes, but differ slightly in their approach. These differences may contribute to their performance (**Figure 2**).

Figure 2

Process for forecasting and managing cash flow in the Home Office and Ministry of Defence



Source: National Audit Office survey

1.9 Although the National Audit Office reported on the accounts of the Department for Work and Pensions in 2004-05 for exceeding one of its annual budget limits¹⁰ as a result of unexpected changes in demand for Income Support and Housing Benefit, it has consistently achieved high accuracy in its cash flow forecasting. This consistency may partly be due to the nature of its expenditure, but also because of the way it manages its staff, systems and processes (**Box 1**).

1.10 The main reason given by central government departments and their sponsored bodies for inaccurate forecasting is their need to make unpredictable capital project or grant payments (**Figure 3**). The 16 sponsored bodies we surveyed need to forecast their cash flows from departmental grants, and more particularly from their other funding sources. Although their sponsor departments rarely collected data or monitored their performance, staff generally considered cash management was a high priority internally.

Box 1

Accurate forecasting – the Department for Work and Pensions

The Department for Work and Pensions has consistently performed well in terms of its cash forecasting accuracy. There are a number of reasons for this:

Nature of business

- The high volume and value of payments made every year means that banking and cash management are a high priority for senior management.
- The majority of benefit and pension payments must be paid on a specific day. In most cases the total payment amount is relatively stable, and so monthly variation in cash flow is much lower than for other departments.

Systems and Processes

- Use of a specialist database which details upcoming benefit payments.
- Trend analysis of past payments to help forecast future payments.
- Strict rules about when large invoices are paid so that the date can be predicted accurately.

Staff

- Succession planning, and having enough people trained in cash management to cover for any key members of staff that are absent or leave the Department.
- The achievements of the cash forecasting team are recognised by senior management.
- Managers at the Department believe that good performance in the past motivates staff to continue to do well.

Source: National Audit Office survey interviews

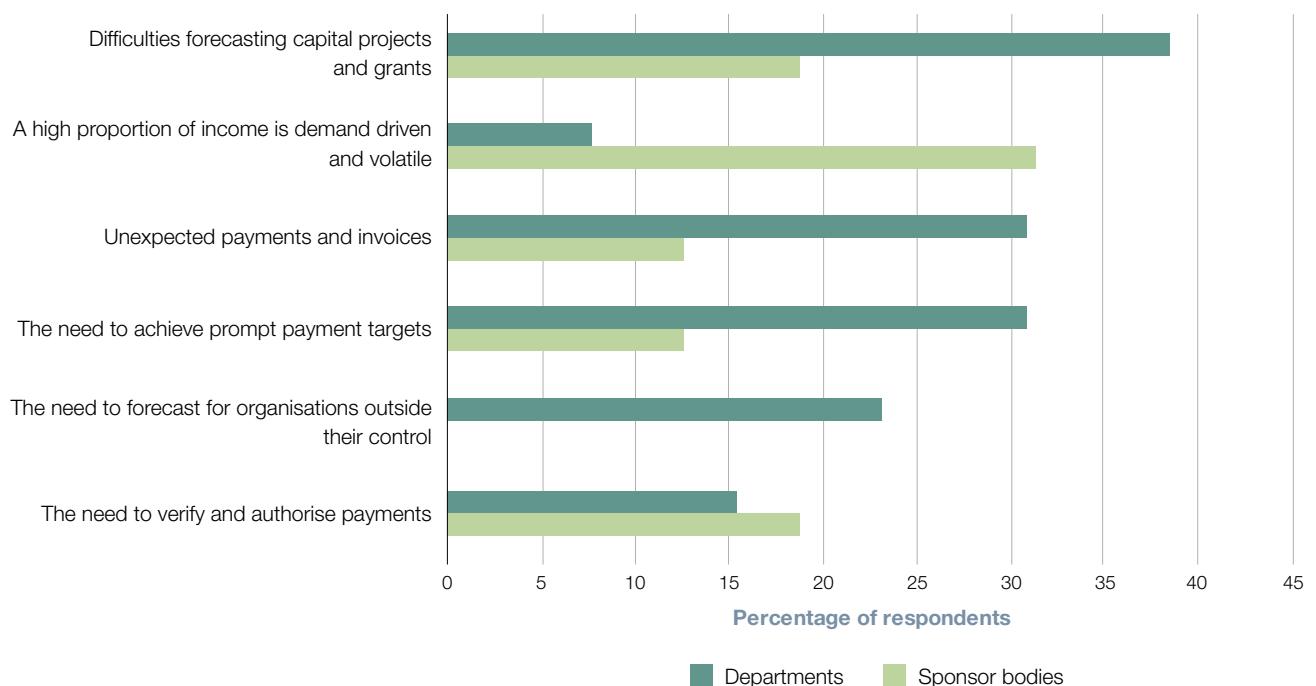
¹⁰ Department for Work and Pensions, Resource Accounts 2004-05.

1.11 Another factor that seems to influence the accuracy of forecasting is the month of the year. In particular, departments consistently produce less accurate forecasts for March. Between 2005-06 and 2008-09 March was the only month in which the forecast error was always greater than £1 billion (**Figure 4** overleaf). This might be partly due to expenditure being highest in March. Between 2005-06 and 2008-09 the 14 departments in our survey collectively spent between £5 billion and £8 billion, or 17 per cent and 24 per cent, respectively, above the monthly average in March.

1.12 One of the keys to accurate forecasting is that business units making large payments need to inform cash forecasters of their intentions. A number of cash managers said they were often surprised by large, unexpected payments, which limits their ability to communicate any changes to the Treasury and the Debt Management Office.

Figure 3

Key reasons given for inaccurate forecasting



Source: National Audit Office survey

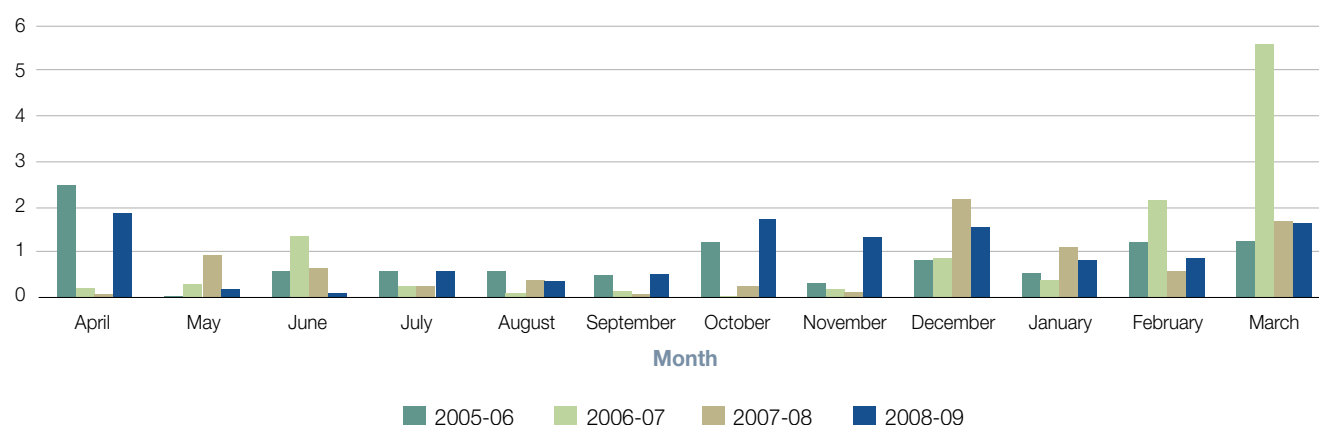
NOTE

Respondents could provide more than one reason.

Figure 4

Monthly cash flow forecast variance between 2005-06 and 2008-09

Forecast variance (£bn)



Source: National Audit Office analysis of HM Treasury Cash Flow Management Scheme data

Actions to improve performance

1.13 Only 15 of our sample of 30 public bodies had internal audit reports relating to cash management or banking in the last five years. Despite this lack of independent review, organisations have attempted to improve their performance with regards to cash management in various ways:

- Some organisations have briefed their business units on the importance of providing accurate forecasts, and to keep the cash managers up to date with any changes within the month. The Home Office, for example, has introduced lunchtime finance seminars that are open to any staff involved in making or receiving payments.
- Ownership and management of cash and banking is often fragmented and the forecasting team can be in an entirely separate location from the payments section. The Department for Culture, Media and Sport has repositioned those individuals responsible for authorising grant payments closer to those responsible for forecasting cash flow to improve communication and interaction. This restructuring means that payments and receipts can be planned more easily, and any changes to the plan communicated.
- Some organisations use formal incentives to drive the desired behaviours. The Nuclear Decommissioning Authority has written cash management requirements into the Site Licence Agreements to incentivise companies to provide more accurate forecasts. It now levies a charge on the companies' working capital to discourage them from offering their sub-contractors extended payment periods at the government's expense.

Keeping cash at the Exchequer

1.14 As at 31 March 2008¹¹, the Treasury estimated that public bodies are holding £4 billion in commercial accounts. Some of this cash is kept in commercial accounts in accordance with legislation, and represents less than four days of central government spending. However, our survey organisations held on average 50 per cent higher cash balances throughout 2008-09 compared to 31 March 2009. While it is not possible to extrapolate from this small sample, it suggests that £4 billion is an underestimate. By minimising the daily balances as well as the year end balance, there is an opportunity to reduce government borrowing.

Banking arrangements

1.15 The most effective method for reducing government borrowing is for all public sector bodies to have a main account at the Exchequer. For example, the Department of Health set a policy that it would only issue cash into Exchequer accounts, and consequently all NHS organisations hold such accounts. While NHS Trusts are free to open commercial bank accounts, having an Exchequer account means government funds are more likely to remain there.

1.16 There are a number of reasons why some organisations hold their cash in commercial accounts rather than with the Exchequer. The Home Office pays police force grants directly into commercial bank accounts because it considers that this maintains police authorities' independence from central government. The reinforcement of its independence from government is also why the Pension Protection Fund prefers to use commercial accounts.

1.17 Other reasons for using commercial accounts are discussed in Part Two, but need to be viewed in light of issues such as credit risk and overall government debt. The National Heritage Act of 1980 states that the National Heritage Memorial Fund receives its entire grant of £10 million at the beginning of the year. It draws down this money into a commercial bank account and invests any surpluses in an endowment fund. The grant payments made by the National Heritage Memorial Fund are sporadic, and so when combined with the balances drawn down from the National Lottery Distribution Fund, it holds relatively high balances outside the Exchequer. The Pension Protection Fund holds levies it collects in its commercial account before investing in financial markets. When markets are volatile, as they were in 2008-09, it holds on to this money for longer, increasing the average daily balance.

¹¹ This is the most recent date for which audited data are available.

1.18 We estimate the 16 sponsored bodies in our survey held on average £275 million a day in their main commercial accounts during 2008-09 (**Figure 5**). If this cash had been in Exchequer accounts, at the prevailing Bank of England bank rate it potentially could have saved £9.1 million in interest on government debt throughout the year, compared to the £7.1 million in interest earned on their commercial bank balances.

Drawing cash from the Exchequer

1.19 Those public sector bodies that draw down money from the Exchequer should do so in a way that minimises cash in commercial bank accounts, and only request the amount of money they require to meet current liabilities. Many of the sponsored bodies in our survey draw down their funding on a monthly basis. However, the Pension Protection Fund generally draws down for its administration operations every quarter, as they are relatively low in value, accounting for just £2 million of the £84 million average daily balance shown in Figure 5. The Identity and Passport Service adjusts the frequency of its drawdowns to take account of revenue from its trading.

Figure 5

Organisations in our sample with the ten highest average daily commercial balances during 2008-09, including balances from non-taxpayer sources

Organisation	Average daily balance (£m)	Balance at 31 March 2009 (£m)
Defence Science and Technology Laboratory	15	7
Identity and Passport Service	21	16
Land Registry	22	22
Legal Services Commission	29	45
National Heritage Memorial Fund	16	4
National Museum of Science and Industry	12	14
Nuclear Decommissioning Authority	14	10
One North East Regional Development Agency	27	10
Pension Protection Fund	84	28
South West Regional Development Agency	18	5
Others	17	22
Total	275	183

Source: National Audit Office analysis of organisations' data

NOTE

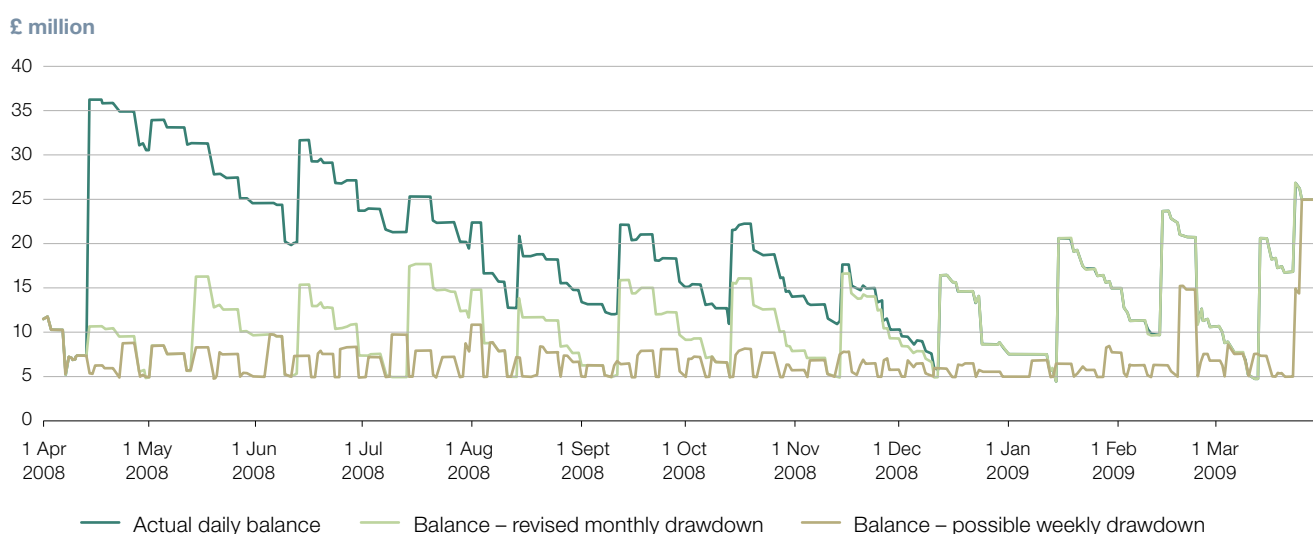
These balances include funds drawn down from departments as grant in aid, as well as funds from other sources, such as charges and levies. Few organisations routinely calculate their daily commercial bank balances, which means that some of these balances are based on sample data. Where organisations have a large number of commercial accounts, data are based on the main current accounts through which most of the funding flows, and exclude any balances held in foreign currencies. These figures are therefore likely to be underestimates of actual balances.

1.20 The Legal Services Commission's arrangement for the account it uses to pay its legal aid clients is to only draw down money based on a confirmed payment run for the following week. Cash will therefore only leave the Exchequer a day before it is needed. It holds a high daily balance to cover for one year's worth of uncashed cheques, although considering the balance across its three main accounts never falls below £14 million, it may be possible to reduce this.

1.21 The South West Regional Development Agency draws down its funding into commercial accounts every month. It expected to make a large land acquisition in early 2008, and so drew down a large proportion of its annual funds, over £30 million, at the beginning of the year. Because the acquisition was delayed until later in the year, it held higher than normal cash balances for the first few months, resulting in an average annual balance of around £18 million. We calculated that if arrangements for drawing down cash had been more flexible, it could have staged the drawdown of this £30 million throughout the year, and while keeping approximately £5 million as a buffer it could have reduced its average daily balance to around £11 million (**Figure 6**), reducing government borrowing by an average of £7 million. If it drew down its funding weekly, like the Legal Services Commission, with some limited additional administrative work it could have reduced its average daily balance further. In this particular example, the organisation has negotiated an unusually high rate of interest from its commercial bank, which offsets the additional costs of government borrowing. However, it demonstrates how commercial balances can be minimised through different approaches to drawing down funds.

Figure 6

Revised model for drawdown of government cash by the South West Regional Development Agency



Source: National Audit Office analysis of South West Regional Development Agency's bank statements

1.22 Organisations that depend mostly on commercial income for their operations, such as Trading Funds and Executive Agencies, need to manage receipts as well as the drawing down of funds. For example, the Central Science Laboratory¹² uses its commercial accounts for all day to day transactions, and its Exchequer accounts either to draw down funding to cover any shortfalls or deposit any surpluses. The Vehicle & Operator Services Agency also uses its commercial accounts for receipts, but in contrast, sweeps any surplus funds into the Exchequer on a daily basis, and makes payments out of these accounts. This second method is more effective at minimising the daily balances in commercial accounts, as it transfers money into the Exchequer daily, rather than on an ad hoc basis. The Central Science Laboratory's average daily balance in commercial accounts is around £850,000 compared to £120,000 for the Vehicle & Operator Services Agency.

Managing payments and receipts

1.23 The main elements of cash flow are creditors, payroll and debtors, and these all can have an impact on the value for money achieved by organisations.

Creditors

1.24 While delaying payments can help to keep money within the Exchequer and minimise borrowing, the government also has a responsibility to pay its suppliers on time. In the past its target was to pay suppliers within 30 days of receiving a valid invoice. The announcement, in October 2008, of measures to support business means government should be paying suppliers within 10 days¹³ and that cash will leave the Exchequer earlier. The Department for Business, Enterprise and Regulatory Reform¹⁴, which is responsible for this policy on prompt payments, analysed departments' existing payment periods and estimated that the move from a 30 day to a 10 day target could cost the government up to £330 million a year in interest payments¹⁵. The benefits of this decision will fall to private sector suppliers, especially small and medium sized enterprises, as it will improve their cash flow.

1.25 The move to the 10-day payment target has caused confusion among public sector bodies. We found a range of interpretations of how promptly organisations are expected to make payments, and to which suppliers the target applies (**Figure 7**).

¹² The Central Science Laboratory is now part of the Food and Environment Research Agency.

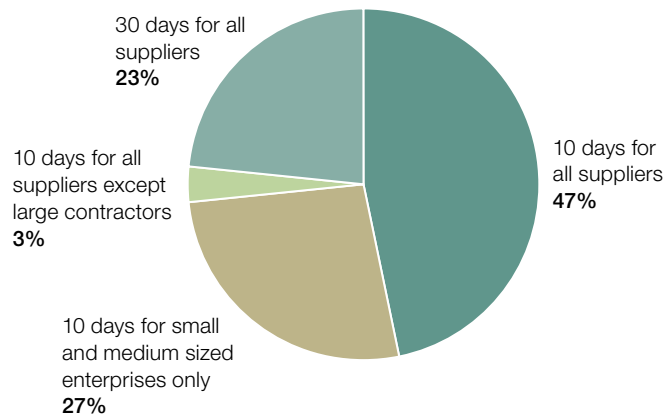
¹³ Secretary of State for Business, Enterprise and Regulatory Reform, October 21, 2008.

¹⁴ This is now part of the Department for Business, Innovation and Skills.

¹⁵ This calculation was based on an interest rate of five per cent. At an interest rate of 0.5 per cent, this impact would reduce to around £33 million a year.

Figure 7

The differing interpretations of the current prompt payment target



Source: National Audit Office survey

1.26 Some staff told us their organisations' focus was on having the correct controls in place rather than achieving the prompt payment target, thus sacrificing timeliness for financial propriety. The conflicting interpretations of the policy make it difficult to directly compare progress towards meeting the 10-day target, but performance of our sample departments does give a broad indication of how quickly businesses are gaining access to government cash. In March 2009, 90 per cent of invoices in the organisations we surveyed were paid within 10 days (**Figure 8** overleaf).

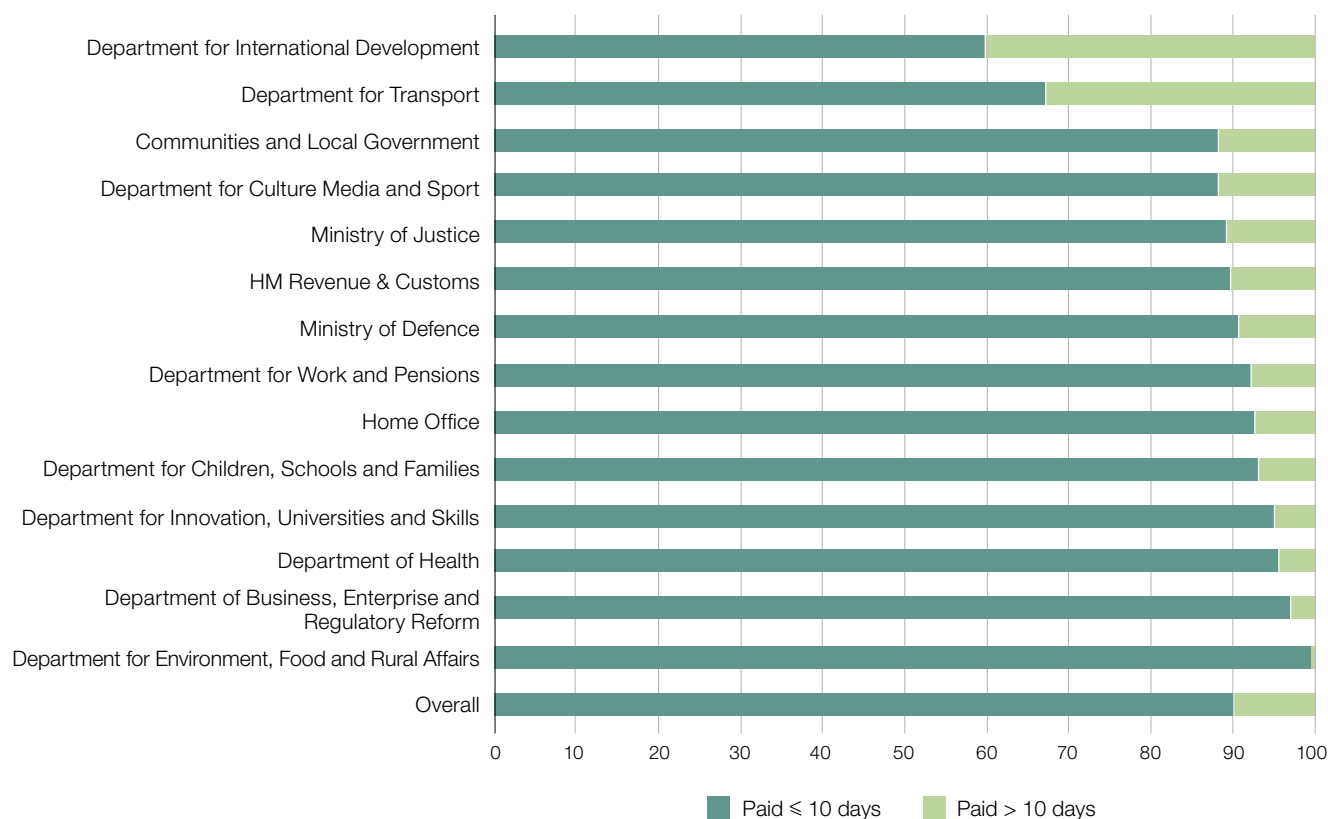
1.27 Organisations face a number of challenges to pay invoices in 10 days. The main issue is getting invoices signed-off for payment. A lack of information on the invoice may make it difficult to match it to the appropriate purchase order, physical circulation of paper invoices takes time, and the necessary staff may be absent. Existing contracts with outsourced payment centres, which may stipulate that invoices are to be paid within 30 days, potentially make it hard to hold private sector companies to account for the 10-day target.

1.28 Electronic invoicing can speed up the payment process. Some of our surveyed organisations identified a need for investment in cash management and banking activities, most of which related to introducing or extending the use of electronic procurement or invoicing. This improves the efficiency of processing invoices and reduces the time it takes to pay them. **Box 2** overleaf sets out the Danish government's adoption of electronic invoicing.

Figure 8

Departments' prompt payment performance in March 2009

Proportion of invoices paid within the timeframe



Source: National Audit Office analysis of data submitted by departments to the Department for Business, Enterprise and Regulatory Reform

Box 2

The introduction of e-invoicing in Denmark

As of 1 February 2005, all public-sector institutions in Denmark only accepted invoices in electronic format. Any company or individual that supplies government organisations with goods or services must complete a standard format invoice containing a purchase order number and a barcode for its location.

At the outset of the scheme, the Finance Ministry calculated the savings that the public sector bodies could make from e-initiatives and cut respective budgets by the savings amount, thereby forcing a multilateral adoption of the e-initiatives. The Ministry of Finance has estimated that the Danish Government is saving around €30 million per annum through this e-invoicing initiative.

Source: National Audit Office review of international comparators, conducted by FTI

Debtors

1.29 Departments and their sponsored bodies receive some of their income from areas other than taxation, such as fees for passports, driving licences, or research services. The sooner this money is collected and banked, the sooner it can earn interest in a commercial bank account, or offset government borrowing in an Exchequer account.

1.30 The internal audit assessments of the public bodies we surveyed concluded that controls on receipts were sound and operating effectively. In organisations where there were substantial numbers of overdue invoices or high levels of duplicate payments, auditors concluded that finance team resources had to be diverted from other duties to cash recovery activities, which would not have been necessary had tighter controls been in place.

1.31 Improving debt management has been a priority for a number of organisations. A National Audit Office report showed that the Department for Work and Pensions improved efficiency and effectiveness of its debt management operations, increasing cash recoveries from £180 million in 2005-06 to £272 million in 2007-08¹⁶. **Box 3** shows how the Driver and Vehicle Licensing Agency has changed its approach to collecting debt.

Box 3

The Driver and Vehicle Licensing Agency's approach to collecting debts

The revenue lost to the Exchequer because of road tax evasion is currently valued at £50 million, equivalent to 0.9 per cent of the total vehicle excise duty collected. The Driver and Vehicle Licensing Agency also received dishonoured cheques worth £2 million, and wrote off a further £2 million in debts that it judged to be unrecoverable. After piloting schemes to improve its management of cash, the Agency now has three contracts with debt collection agencies to collect a range of these unpaid debts, but particularly from car owners who missed paying their road tax by one month or more during 2008-09. Cases are referred to the debt collection agencies as appropriate, and the companies are paid commission on the amount of cash they recover. These actions contributed to the collection of £52 million of tax revenue through enforcement activity in 2008-09.

Source: National Audit Office analysis of the DVLA Annual Report & Accounts 2008-09

¹⁶ Management of Benefit Overpayment Debt, National Audit Office, HC 294 2008-2009.

Governance

Management of the delivery chain

- 1.32** The key relationships in the delivery chain for cash management are between: HM Treasury and central government departments; the departments and their sponsored bodies; and the Board of an organisation and the organisation itself.
- 1.33** The Treasury has an Exchequer Funds and Accounts team, which among other functions coordinates the cash flow across government. While departments are responsible for forecasting their own cash flows and submitting them to the Treasury, the Treasury uses incentives to drive the appropriate behaviour. To embed this behaviour, it hosts an annual cash management seminar to reinforce the importance of good cash management and to share experiences across departments.
- 1.34** The Treasury communicates the principles of cash management to public sector bodies through its financial guidance document *Managing Public Money*¹⁷, but does not have a systematic programme for enforcing compliance with them. While organisations are responsible for applying the guidance, some of the sponsored bodies we surveyed were not aware of its existence as a source of guidance in this area, and even those that were aware of it did not always apply the principles (**Figure 9**).

Figure 9
Adherence of public sector bodies to HM Treasury’s three key principles of cash management and banking

Principles	Evidence and conclusions
1 It is essential for departments and Non-Departmental Public Bodies to minimise the balances in their own accounts with commercial banks.	The Department for Culture, Media and Sport does not have any commercial accounts. Of the other departments, all have policies to minimise the balances held in commercial accounts. Some non-departmental organisations have active arrangements to minimise commercial bank balances. Examples include using Exchequer accounts for the majority of ‘business’ transactions or reducing the frequency of draw down. However, six of the 16 organisations in our survey did not have an Exchequer account.
2 It is good practice for each organisation in central government to establish a policy for its use of banking services.	Only a third of organisations which we surveyed, and that had commercial accounts, provided written policies on the use of such accounts.
3 Sponsor departments should make sure that their Arm’s Length Bodies are aware of the importance of managing this aspect of their business efficiently and effectively.	Some departments set out their expectations on cash management and banking within the Financial Memoranda or Finance Manuals for their sponsored bodies, but many delegate this function entirely.

Source: National Audit Office survey interviews

17 *Managing Public Money*, HM Treasury, October 2007.

1.35 Central government departments need good information from their sponsored bodies to stay within their cash spending limit for the year. We found, however, that most of the departments did not request information about their sponsored bodies' cash requirements and usage, other than basic cash flow forecasts.

1.36 Many organisations told us that strong interest in cash management and banking from the Board helps focus staff's attention. The Boards of bodies like Trading Funds receive management information on their organisations' cash position on a regular basis, which helps them drive improvement (**Box 4**). Although the remainder told us that their Boards discussed cash flow on an exception basis, the current economic climate, greater scrutiny from the Treasury, and the arrival of new senior managers have meant that organisations have generally increased their attention on cash management.

Box 4

Using information to improve cash management at the Defence Science and Technology Laboratory

At its inception in 2001, the Defence Science and Technology Laboratory had more liabilities than its net worth of £40 million. It does not draw down any direct government funding, but is paid mainly on a cost-plus basis by the Ministry of Defence for the work it undertakes.

Given these circumstances, the finance team had to manage expenditure very tightly, maintaining working capital broadly equivalent to the monthly payroll liability of £10 million, and prioritising payments when cash was in short supply. Senior management encouraged the necessary improvements by requiring:

- the Management Accountants based with each of the operating departments and the central functions to produce full cash analyses in their quarterly accounts packs;
- the Treasury Manager to produce day-by-day forecasts of expected cash flows from the opening bank balance, and a weekly cash flow forecast with a summary of the debtors position; and
- the Head of Finance to build a monthly cash flow model with both an optimistic and pessimistic position.

Within the first two years of trading, the Defence Science and Technology Laboratory had corrected its problems with its cash position. Since 2001, the Treasury function has earned £26 million in interest. The finance team predict that changes made since April 2008 will considerably improve the cash position and may allow them to reduce the working capital limit.

Source: National Audit Office survey interviews

Incentives

1.37 Simply having a process in place is often not sufficient to motivate the right behaviour. Sometimes formal incentives can address this, but they must be well designed and implemented to prevent unintended consequences. The Treasury uses two formal incentive mechanisms to encourage good cash management (**Box 5**).

1.38 There are a number of criteria to which incentive mechanisms should adhere if they are to be effective. Our review of the two incentive mechanisms described above suggests there are a number of strengths as well as weaknesses (Appendix Eight).

Box 5

The Treasury's cash management incentive mechanisms

Cash Flow Management Scheme

Introduced in 2001, the scheme requires all central government departments to submit both a monthly and a daily forecast of net expenditure. At the end of each month, the Treasury compares the actual cash flows against these forecasts, and applies a notional financial charge depending on their performance. The total charges and rebates are then aggregated, leaving a final year end net charge or rebate in direct proportion to each department's annual expenditure. A department that incurs more charges than it earns in rebates has its End Year Flexibility reduced, and vice versa – End Year Flexibility is the amount of unspent money that departments can carry forward as expenditure in the next financial year.

All departments, regardless of the size of their budget, are expected to be accurate to within five per cent of their forecast. The Treasury publishes a monthly league table which allows departments to compare their performance against that of others. The charges, rebates and league tables are based on the following performance measures and targets:

- Forecast total monthly expenditure to within five per cent.
- Forecast monthly BACS payments.
- Forecast daily BACS payments to within £15 million.
- Forecast daily CHAPS payments to within £5 million.

Cost of capital charge

A notional charge which is applied to the accounts of each public sector body within the remit of HM Treasury, other than trading funds, based on the value of working capital. As funds held within the Exchequer only become working capital when they leave it, the charge only applies to cash held in commercial accounts.

Source: National Audit Office survey interviews

1.39 The main strength is that the Cash Flow Management Scheme uses a combination of financial incentives in the form of charges and rebates, and non-financial incentives in the form of league tables. This approach recognises that individuals are not only motivated by rewards and penalties but their standing amongst peers as well. The publication of the league tables across departments gives transparency to departments' performance on both a monthly as well as annual basis. This exerts peer pressure, as Finance Directors and their staff want to be seen to be performing well, and avoid being at the bottom of the table. The Treasury also demonstrated good practice in piloting the Scheme in a few areas to test its validity before rolling it out across all departments.

1.40 An incentive mechanism should be linked as directly as possible to the desired objective. The main weakness of the system is that there is a Cash Flow Management Scheme which has been successful in focusing departments on accurate forecasting, but there is no equivalent system of incentives to keep cash in the Exchequer, which is where most of the benefit for the taxpayer lies. Although the Treasury publishes guidance that requires organisations to minimise commercial balances, this is not systematically enforced or supported by any incentives.

1.41 The Danish government uses an alternative cash management model, in which all central government's banking is managed through the one commercial bank, and only in extremely rare cases do public sector organisations have accounts with other banks (Appendix Seven). To reduce government borrowing by keeping funds within the Ministry of Finance, the Danish government pays interest on cash balances, with the rates dependent on the type of account. However, this means the government may need to borrow additional money to pay the interest. HM Treasury does permit the payment of interest on some cash balances at the Exchequer for public bodies with certain legal governance arrangements, such as NHS Foundation Trusts. The most cost-effective model would be for all public bodies to bank with the Exchequer and manage their cash in accordance with the guidance without the need for incentive payments.

1.42 The Treasury does not believe the cost of capital charge is an effective deterrent. This may be because it is a notional figure that is only calculated once a year for the annual accounts, and so does not give transparent or frequent enough information on how well departments are performing in keeping their money with the Exchequer. As part of its Alignment Project¹⁸, the Treasury is looking to replace the charge with an alternative sanction.

¹⁸ Also known as "Clear Line of Sight", this is a project managed by the Treasury to simplify financial reporting to Parliament by making the three elements of government financial management – budgets, estimates and accounts – more consistent.

1.43 The Department of Health is the only department we surveyed which has levied a penalty on some of the sponsored bodies that lie within its accounting boundary – NHS Primary Care Trusts and Strategic Health Authorities – for having excessive commercial bank balances. While these bodies retain the flexibility to use the wide variety of services provided by commercial banks, they are given an incentive to keep as much money as possible in the Exchequer.

1.44 In some cases the Cash Flow Management Scheme can have unintended consequences. If there is an unexpected invoice or receipt, some departments told us they intervene in payment runs to delay or bring payments forward to match the original forecast. This can be contrary to government guidance on both prompt payment to suppliers, and not making payments before they are due to other public sector organisations.

Skills and resources

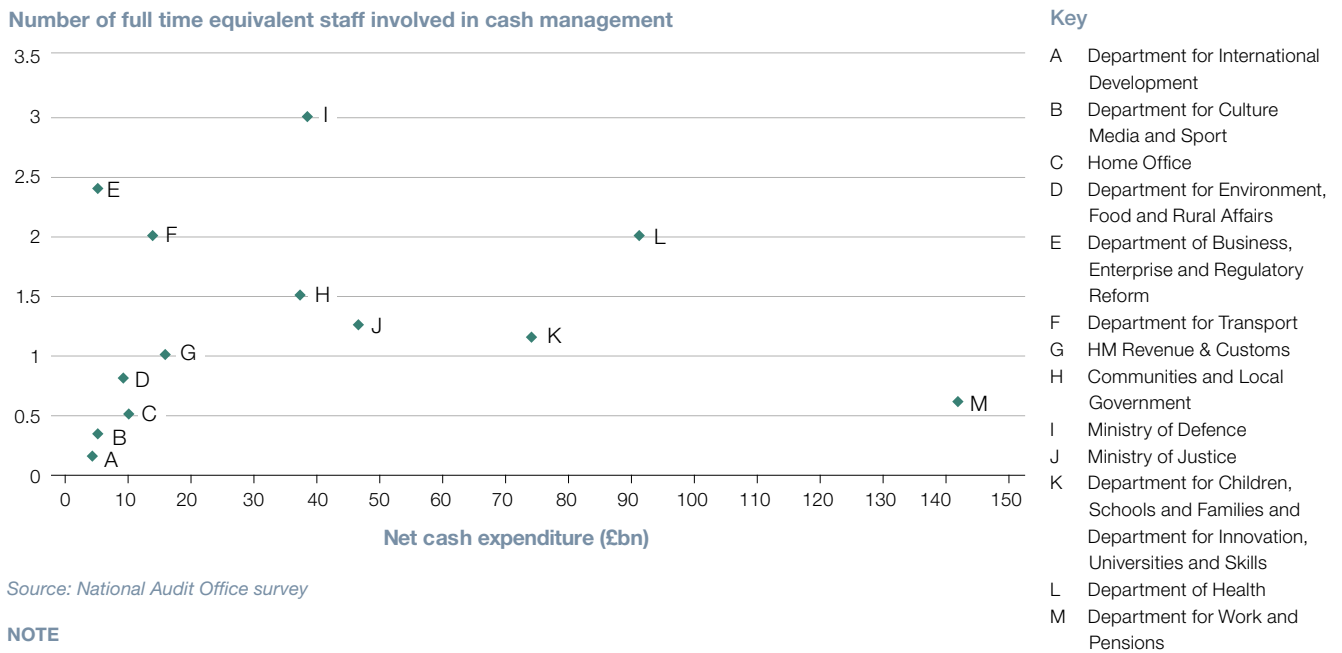
1.45 Organisations apply very different levels of human resources to cash management. Few Finance Directors or finance staff had measurable objectives for cash management, although some did have targets for prompt payment and level of working capital, which are related. Organisations generally divide responsibilities for cash management across their whole finance team. We found no clear correlation between the number of people involved in departments' cash management and their net cash expenditure (**Figure 10**).

1.46 Finance teams considered their staff to be sufficiently competent to manage government cash by virtue of being at least part qualified finance professionals and their experience in cash management – on average 5.7 years, with only 17 per cent having less than three years' experience. The Ministry of Defence has introduced its own programme of financial training with a qualification that includes a module on cash management, while the finance staff at the University of Warwick regularly draw upon the experiences and opinions of colleagues in other higher education institutions (**Box 6**).

1.47 Organisations felt that an estimate of the cost to the taxpayer of poor cash management would enable them to evaluate the benefits of employing additional staff – potentially with more commercial experience in forecasting, investment and payment performance – against their salary costs. We found one of the key reasons for overall inaccurate government forecasting is poor predictions of the dates on which large businesses make their tax payments. HM Revenue and Customs previously employed staff specifically to liaise with large businesses to predict the size and date of payments, but this team was disbanded.

Figure 10

Relationship between the number of full time equivalent employees and net cash expenditure in 2008-09



Source: National Audit Office survey

NOTE

Net cash expenditure is the amount of cash each department received from Parliament and spent, after taking income into account. For the Department of Health and the Department for Work and Pensions this includes money spent out of the National Insurance Fund, but for HM Revenue and Customs excludes any income from tax receipts.

Box 6

Knowledge sharing between higher education institutions

The University of Warwick has been proactive in sharing knowledge and good practice in the management of cash. As well as working with financial consultants and investment brokers, the higher education sector regularly holds meetings such that university Finance Directors can discuss issues. There are also online discussion forums through the British Universities Finance Directors' Group which all staff in finance can log onto. Questions can be posed and discussed, and resources can be shared. Investments, banking charges and e-procurement systems are examples of the topics that have been covered.

Source: National Audit Office survey

Part Two

Banking services

2.1 Banking arrangements are central to how public bodies can get value for money from their cash management. This Part of the report examines:

- the management of banking services; and
- how organisations manage the risks associated with cash and banking.

Managing banking services

Selection of service providers

2.2 It is mandatory for departments to have accounts at the Exchequer, but not for other types of public body. In 2008-09, public bodies collectively paid £7.5 million to make transactions and use Exchequer accounts.

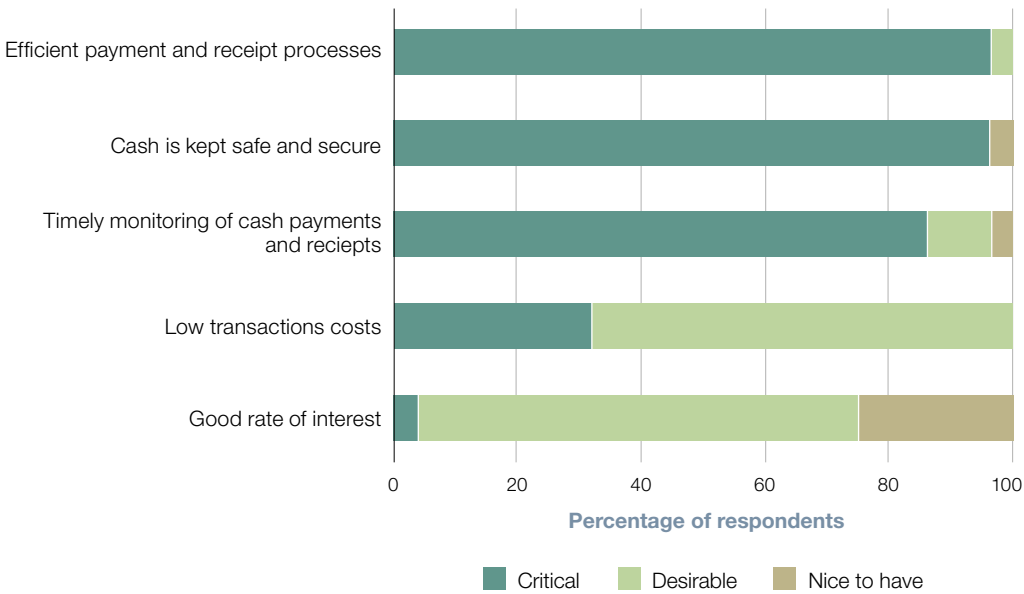
2.3 In the past, Exchequer accounts were managed by the Office of HM Paymaster General. This organisation has now been incorporated into the Government Banking Service, which was launched in May 2008 in response to the Bank of England's announcement that it would stop providing retail banking services. The Government Banking Service is still using the banking arrangements that existed under the Office of HM Paymaster General, but is piloting new arrangements based on contracts with two commercial banks, Royal Bank of Scotland and Citibank (Appendix Four). It intends to move its existing customers over to these new arrangements by the end of 2010. Guidance issued by the Treasury states that "Each public sector organisation should run its cash management and money transmission policies to minimise the cost to the Exchequer as a whole. This usually means using the Government Banking Service."¹⁹

¹⁹ Annex 5.7, *Managing Public Money*, HM Treasury, December 2008.

2.4 Many factors can affect an organisation's selection of banking service provider. The organisations we surveyed rated the security of their money as the most critical aspect of service, followed by efficient payment and receipt processes, and the ability to monitor transactions in a timely manner (**Figure 11**).

2.5 Historically, the Office of HM Paymaster General did not provide all the services offered by commercial banks. As a result, most departments and their sponsored bodies have contracts with the commercial banking sector either as well as, or instead of the Office of HM Paymaster General. **Figure 12** overleaf shows the main reasons why public bodies have commercial bank accounts, although in some cases these may have been based on perceptions of the services offered by the Office of HM Paymaster General rather than reality.

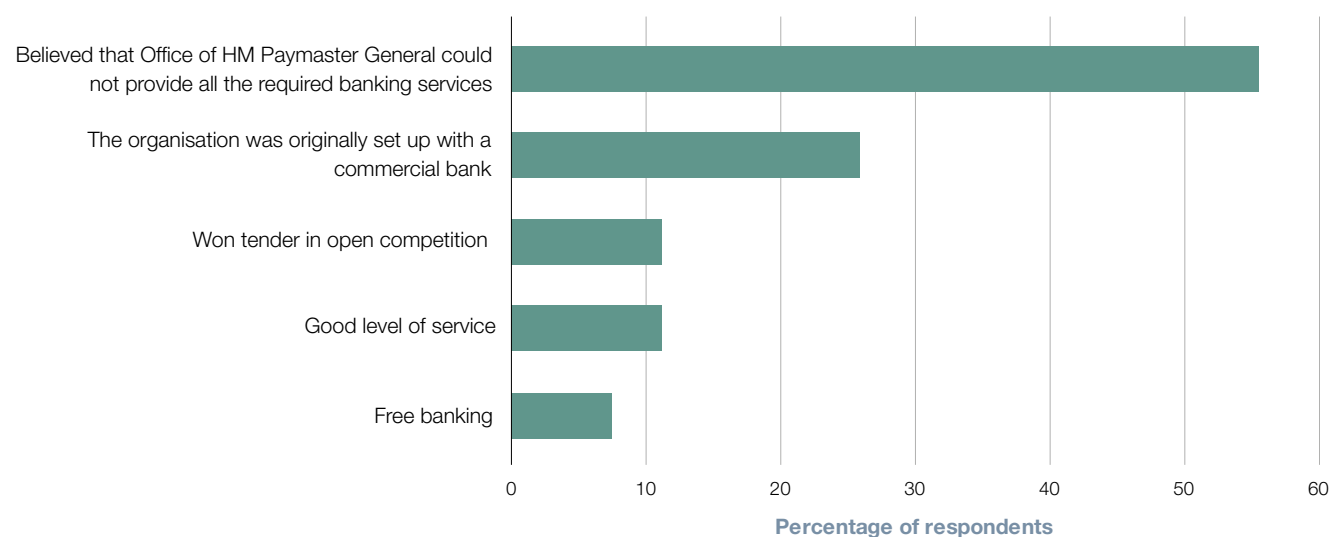
Figure 11
Relative importance of various banking features for public bodies



Source: National Audit Office survey

Figure 12

Reasons why departments and their sponsored bodies chose commercial bank accounts



Source: National Audit Office survey

NOTE

Respondents could provide more than one reason.

2.6 The Government Banking Service, however, having taken over the role of the Office of HM Paymaster General, will soon offer the full range of standard banking transactions and account management functions to the public sector through the Royal Bank of Scotland and Citibank. Transactions from Exchequer accounts also have an advantage for the taxpayer over commercial accounts for the following reasons:

- the Internal Transfer system offers a same-day, free of charge, and completely secure method of transferring funds between Exchequer accounts; and
- automated payments (BACS) are deducted from accounts on day three of the three day processing cycle, which keeps the funds in the Exchequer for two days longer than the service provided by commercial banks.

2.7 Despite the benefits of these transaction processes, the Government Banking Service is at a disadvantage when competing against commercial banks in tendering exercises. This is because commercial banks interact with the money markets directly, and can offer various combinations of transaction fees and interest rates to win a contract, while the Government Banking Service can only offer standard transaction fees and only pay interest if the Treasury agrees.

Procuring and monitoring banking services

2.8 Of the 16 sponsored bodies we surveyed, only two have changed their banking provider in the last 10 years, with most simply rolling contracts forward and carrying out occasional benchmarking to check they are still getting value for money. This inertia minimises the cost and effort of transferring banking provider, but means that organisations are not always using open competition to get the best value for money. However, the establishment of the Government Banking Service means that organisations no longer need to go out to open tender when procuring banking services, saving time and resources. But, where public bodies need specialised banking services, the Government Banking Service is not yet providing a mechanism for systematically sharing information, which could help with tender specifications and judging value for money.

2.9 The public bodies we surveyed generally used their internal procurement specialists to assist with drawing up the specifications for banking tenders, though the Land Registry also used specialist consultants. A common problem we found is that the requirements were generally based on historic volumes and types of transactions, rather than taking account of future trends.

2.10 Once an organisation has put a banking contract in place, it needs to manage the contract. Most organisations do not use formal indicators to monitor banks' performance, but prefer to manage any issues as they arise. The Department for Work and Pensions does use formal performance measures because the efficiency of its cash management, in the form of making timely benefit payments to those entitled in a cost effective manner, is one of its core objectives.

Fees and interest rates

2.11 A report on government banking estimated that if the lowest cost of current transactions could be achieved across the public sector then around 25 per cent of total expenditure on bank charges could be saved, even before gains from economies of scale were considered²⁰. **Figure 13** overleaf shows the range of fees paid by our survey organisations for the standard banking transactions.

²⁰ *Chancellor's Departments Banking Project Report*, HM Treasury, 2004.

2.12 A key reason for these variations is that banks set charges partly based on the levels, frequency and cycle of payments and receipts made through bank accounts. High fees for some transactions may be offset by negligible charges for others, or for additional services, such as bank reconciliations and corporate cards, that a bank is offering free of charge.

2.13 There is a risk, however, that focusing purely on transaction fees and interest rates may lead to organisations negotiating banking contracts that offer poor value to them and government as a whole. **Box 7** shows that while some of the pricing structures offered by commercial banks provide good value for money for organisations individually, because they involve holding money outside the Exchequer, they increase government borrowing and the associated interest payments borne by the taxpayer.

Figure 13

Comparison of payment fees and interest rates

	Lower quartile	Median	Upper quartile
BACS per item	0.5p	2p	3p
CHAPS per item	£4.50	£7	£12
Cheques per item	2.5p	6.25p	15p
Interest rates earned on credit balances	0 per cent	Base minus 1 per cent	Base minus 0.25 per cent

National Audit Office survey

NOTE

The inter-quartile range shows the variation in fees and interest rates for half the organisations, without the distortions of the lowest 25 per cent or highest 25 per cent. This means that 25 per cent of public bodies in our survey had fees or interest rates equal to, or lower than the ones shown as the 'lower quartile', and 25 per cent had fees or interest rates equal to, or higher than the ones shown as the 'upper quartile'

Box 7

Examples of pricing structures offered by commercial banks

- **Charging zero transaction fees and paying no interest.** This pricing structure is good for the organisation because bank fees come out of its budget, and in most cases any interest earned will be returned to the Treasury.
- **Requiring an organisation to maintain a minimum balance in its account in exchange for lower transaction fees.** The organisation saves on its administration costs, but is holding money outside the Exchequer.
- **Applying a notional rate of interest on accounts and requiring the organisation to adjust its balance so that the earnings from the notional rate of interest cover the transaction costs.** For example, if the standard balance of the account is £500,000, standard monthly transaction charges are £10,000 and the notional interest rate is two per cent, when transactions rise and the cost increases to £15,000, then the organisation would need to increase the monthly balance to £750,000.

Source: National Audit Office survey interviews

Methods of payment

2.14 The payments industry intends to phase out the use of cheques because electronic methods of payment are cheaper, more reliable, and less open to fraud. The initial target to eliminate all cheques was 2018, but this is being reviewed based on the lack of acceptable alternatives.

2.15 Our survey indicates that most payments by public bodies out of commercial accounts are already made electronically (**Figure 14**). The most cost-effective method is for payments to be made by BACS, but poor forecasting means urgent or one-off payments are still sometimes made by CHAPS or cheque.

2.16 There is no government-wide plan for phasing out cheque payments. The Legal Services Commission, for example, pays all of its clients by cheque, because they are generally one-off payments and they judge it not to be cost-effective to enter each individual's bank details into their system. Denmark has already made the switch from cheque payments to direct electronic payments (**Box 8** overleaf). As well as the cost of making payments by cheque, there are also cost implications for receiving payments by cheque. The Land Registry still receives payment for the bulk of its services by cheque, at an additional cost compared to BACS of £38,000, but has initiated a project to receive more fees by variable direct debit.

Figure 14

Proportion of payments made from commercial bank accounts using different methods

Payment method	Lower quartile (%)	Median (%)	Upper quartile (%)
BACS	80	93	98
CHAPS	0	0.7	1
Cheques	0.5	5	10

Source: National Audit Office survey

Box 8**Use of electronic payments to citizens and companies in Denmark**

In Denmark all individuals and companies are required by law to nominate a bank account to receive electronic payments from public bodies. This account ('Nemkonto'), which is to be linked to a social security or company registration number, can be an existing current account held by a company, an individual, or family member with a Danish bank. There are a number of benefits:

- all payments can be received electronically, which saves time and effort;
- public offices' processing costs and bank charges are lowered as they do not need to make cash or cheque payments; and
- individuals can change their bank account nomination online or in a bank, potentially increasing accuracy and reducing work for the public authorities to update information.

The Danish Ministry of Finance estimates a total saving of approximately €70 million per annum from the 'Nemkonto' initiatives.

Source: National Audit Office review of international comparators, conducted by FTI.

Specialised banking services**Secure cash transit and payment card processing**

2.17 For those organisations that collect large sums of revenue, secure cash transit and credit card fees make up most of their banking costs. Because most of its banking activity is through electronic transactions, in 2008-09 the Driver and Vehicle Licensing Agency spent £9.6 million on credit and debit card fees and £220,000 on secure cash transit services, compared to £228,000 on routine bank charges. The two bodies in our survey that are sponsored by the Department for Transport had undertaken a shared tender to achieve better value for money from their cash transit services, and there may be scope for others to negotiate more collaborative contracts.

Foreign exchange

2.18 Public sector organisations sometimes need to make payments overseas, many of them in Euros and US Dollars. Some departments, such as the Ministry of Defence, carry out some basic currency hedging called 'forward purchase', while others, such as the Department for International Development, do not. Purchasing currency over time through 'forward purchase' mitigates the risk of large unforecast exchange rate fluctuations, and reduces uncertainty over the sterling cost of expenditure in foreign currencies. However, it does not guarantee lower costs, and may lead to substantially higher costs, depending on market conditions. Because of the various circumstances in which foreign currency is exchanged and the wide variety of techniques that are available, Managing Public Money aims to alert public bodies to this complexity and advises them to consult with the Treasury before carrying out any hedging activities.

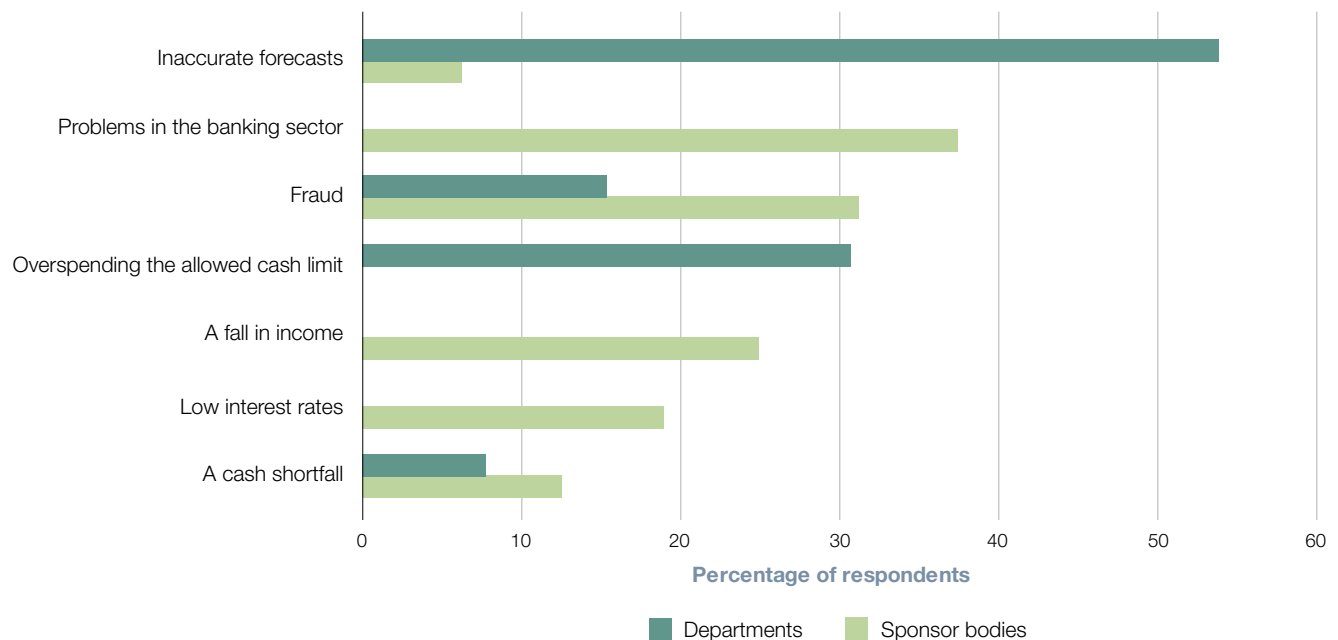
2.19 There are ways for departments to get better value from their overseas payments. The Department for Work and Pensions has a contract with a bank to pay United Kingdom pensioners overseas electronically, on the basis that it offers a preferential rate of exchange and lower transaction costs for the citizen. Even in countries where there are fixed bank charges and less mature banking systems, government organisations, such as the Department for International Development, the Foreign and Commonwealth Office and the British Council, are transferring money to the same countries independently. This not only incurs multiple bank charges, but means that each organisation is holding foreign currency reserves independently, increasing the overall cash balances unnecessarily.

Risks

2.20 We asked our survey organisations to identify their top three risks in relation to cash management and banking. The most significant risks for departments centred on cash management, while the sponsored bodies were focussed on earning income and banking services (**Figure 15**).

Figure 15

Perceived risks regarding cash management and banking



Source: National Audit Office survey

Credit risk

2.21 Credit risk was one of the risks being monitored by the bodies we surveyed, but across government we did not find an over dependency on any one bank. Based on our survey, only a third of departments with sponsored bodies were aware of the banking arrangements of their bodies. In response to the collapse of Icelandic banks, a few of the departments and regulatory bodies we interviewed undertook an investigation to identify if there was any exposure to financial loss. These organisations reported that NHS Foundation Trusts and their charities had a total of £8.5 million invested in Icelandic banks²¹, higher education institutions had £77 million²², and one Non Departmental Public Body had £10 million²³. Not all of this money was public funding, however, but came from a variety of sources, such as charitable donations²⁴.

Investment risk

2.22 Nearly half the sponsored bodies we surveyed have a policy on how to invest surplus funds, although with respect to short-term cash surpluses they are often less formal and left to individuals' discretion. Policies generally specify that cash should be held in United Kingdom regulated banks and building societies, as they offer more security.

2.23 The range in the level of investment activity was considerable. Where current accounts offer little or no interest, some organisations use sweep facilities, which transfer daily closing balances from a current account into a higher interest bearing account overnight before transferring them back into the current account the next morning.

2.24 Where organisations have Investment Committees for the management of endowments or long-term surpluses, the membership generally included people with banking and financial experience. Most Committees follow a conservative strategy focussing on the National Loans Fund and other HM Treasury investment products such as gilts (**Box 9**).

²¹ Commons Hansard, 14 October 2008, Column 38WS.

²² Commons Hansard, 14 October 2008, Column 40WS.

²³ Commons Hansard, 10 March 2009, Column 68WH.

²⁴ Other investigations have revealed that more public bodies have funds in Icelandic accounts, particularly Local Authorities and charities.

Box 9**The management of investments by the National Museum of Science & Industry**

In 2007-08 the National Museum of Science & Industry's total income was around £62 million, of which £34.5 million was a grant from the Department for Culture, Media and Sport. It also receives grants from bodies such as the Heritage Lottery, Regional Development Agencies and charitable arms of large companies for specific projects, and so a portion of the funds have restrictions on their use. An assessment of funding risks and the likelihood of them materialising, and the trends over the last five years, have resulted in the Trustees setting a contingency fund target of around £2.2 million.

The Trustees have been empowered to invest since 2000, and their policy is to maintain the value of all funds identified as surplus to working capital over time, with no emphasis on capital growth. Due to its charitable status, the organisation has a low appetite for risk, and so the Trustees have chosen to achieve their aims by holding funds with one bank. Given the size of the surplus and the maturity of the bank, and by investing directly in gilts, the Trustees' view is that there is little danger of the loss of funds.

Cash balances are reviewed by the finance team on a daily basis and £100,000 is kept within the current account to cover for any uncleared transactions. The excess is placed on deposit overnight or for any period from a week to 12 months. Any transfer outside of the bank requires the permission of the Board, and gilts are purchased when cash is available in the longer-term. The investment position is reviewed on a regular basis by the Finance and General Purposes Committee and scrutinised by the Audit Committee.

Source: National Audit Office survey

2.25 We found some inconsistency in the practice and understanding about where funds could be held or invested, and for how long. In some cases where organisations had been set up with a commercial account, such as Regional Development Agencies and Development Corporations, staff did not realise that having an account with the Exchequer was possible. Regarding investments, the Department for Transport's arrangement with the Driver and Vehicle Licensing Agency only permits the investment of surplus funds in the government's National Loans Fund, which directly offsets government borrowing, while the Defence Science and Technology Laboratory can make short term investments in the commercial sector in accordance with the Treasury's guidelines.

Appendix One

Summary of methodology

1 The following table provides a brief description of the key methods used in the study. A more complete methodology is available in Appendix Two which is published along with the other Appendices on the National Audit Office's website: www.nao.org.uk.

Method	Brief description	Use of evidence in the report
Structured survey	We conducted a survey through structured interviews with 14 central government departments and 16 sponsor bodies. The table opposite gives a full list of organisations included.	This provided a broad overall understanding of cash management and banking issues across government, which formed the basis for much of the report.
Quantitative data analysis	<p>This included analysis of:</p> <ul style="list-style-type: none"> ● answers in the survey which could be quantified; ● accuracy of departments' cash flow forecasting accuracy; ● the commercial bank balances of sponsored bodies throughout 2008-09; ● public bodies' commercial bank charges and interest rates; ● timeliness of invoice payments; and ● the variety of payment methods used. 	<p>We used this analysis to:</p> <ul style="list-style-type: none"> ● demonstrate variation across government bodies; ● assess trends in performance; and ● quantify the financial implications of current levels of performance.
Qualitative data analysis	<p>This included analysis of:</p> <ul style="list-style-type: none"> ● answers in the survey that could not be quantified; and ● board and internal audit reports. 	<p>We used this analysis to:</p> <ul style="list-style-type: none"> ● provide case studies based on public bodies' experiences; and ● understand the issues faced by public organisations in managing their cash and banking arrangements.
Semi-structured interviews with stakeholders	<p>We conducted interviews with staff from:</p> <ul style="list-style-type: none"> ● HM Treasury's Exchequer Funds and Accounts team; ● the Debt Management Office; and ● the Government Banking Service. 	These gave the perspectives of the key central stakeholders which were essential for many elements of the report.
International comparisons work	We commissioned FTI, a specialist treasury consultancy, to review the cash management and banking arrangements in Canada, Denmark and South Africa.	This provided case study examples to illustrate some alternative approaches to cash management and banking.

Departments and the associated public sector organisations we surveyed

Department	Sponsored bodies
Department for Business Enterprise and Regulatory Reform (now part of the Department for Business, Innovation and Skills).	One North East Regional Development Agency. South West Regional Development Agency. Nuclear Decommissioning Authority. (now part of the Department of Energy and Climate Change).
Department for Children, Schools and Families	The British Educational Communications and Technology Agency.
Department for Communities and Local Government	Thurrock Development Corporation.
Department for Culture, Media and Sport	National Heritage Memorial Fund. National Museum of Science and Industry.
Department for Environment, Food and Rural Affairs	Rural Payments Agency. Central Science Laboratory (now part of the Food and Environment Research Agency).
Department for Innovation, Universities and Skills (now part of the Department for Business, Innovation and Skills).	None surveyed. However, we interviewed staff at Warwick University and reviewed documentation from the Higher Education Funding Council for England.
Department for International Development	None surveyed. However, we interviewed the cash management staff of two country offices: <ul style="list-style-type: none"> • Democratic Republic of Congo. • Ethiopia.
Department for Transport	Driver and Vehicle Licensing Agency. Vehicle & Operating Services Agency.
Department for Work and Pensions	Pension Protection Fund
Department of Health	None surveyed. However, we interviewed staff at Monitor, who regulate NHS Foundation Trusts.
Her Majesty's Revenue and Customs	None surveyed. However, we interviewed staff at the Government Banking Service.
Home Office	Identity and Passport Service.
Ministry of Defence	Defence Science and Technology Laboratory.
Ministry of Justice	Legal Services Commission. Land Registry (although the Land Registry reports to the Secretary of State for Justice and Lord Chancellor, as a trading fund it is independent of the Ministry of Justice and a government department in its own right, and so does not receive any direct funding from the Ministry of Justice).



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