National Audit Office

Government cash management

Appendices two to eight

Contents

Appendix Two

Scope and Methodology

Scope of the study

1 This report examines the management of cash by central government departments and their sponsored bodies. It covers around £400 billion of the government's total spending of £600 billion, which is the money given by Parliament to the 14 departments covered in this report, and so excludes National Insurance and local taxes. It does not review the cash flow implications of tax revenues collected by HM Revenue and Customs. Our work focussed on two main areas:

- how public bodies manage their cash flow throughout the year; and
- the bank transactions and accounts that make this possible.

2 We reviewed the cost and risk implications of keeping money outside the Exchequer, as well as the costs of inaccurate forecasting and different methods of payment. We included a review of the role of the Treasury in coordinating government's overall cash flow, and how this affects the Debt Management Office's ability to obtain value for money. We covered how the current economic crisis has affected banking arrangements and the early experiences that public bodies have had of the new Government Banking Service. It does not address the performance of the Debt Management Office or the Government Banking Service.

Fieldwork methods

3 Our findings, conclusions and recommendations are based on:

- a survey completed through interviews with 14 central government departments, 16 organisations from the wider public sector and two international offices of the Department for International Development;
- a review of documents and analysis of data relating to those departments and organisations' cash management and banking arrangements;
- a high level review of the arrangements in NHS Foundation Trusts and Higher Education Institutions;
- an analysis of departments' cash flow forecasting accuracy collected by the Treasury for its Cash Flow Management Scheme;

- semi-structured interviews with the Treasury and the Government Banking Service on their roles and responsibilities for government-wide cash management and banking; and
- a review of three international governments conducted by specialist treasury consultants to compare cash management and banking processes.

Survey of 14 central government departments and 16 wider public sector organisations

4 We carried out structured interviews with 14 central government departments and 16 public sector organisations between December 2008 and April 2009. Staff responsible for cash flow forecasting and day to day cash management and banking answered questions under seven themes:

- Cash flow forecasting.
- Prioritisation of cash management.
- Payments and revenue.
- Banking arrangements.
- Risks.
- Governance.
- The relationship between central government departments and their associated public bodies.

5 Due to the complex nature of the questions, we felt that interviews were likely to elicit more reliable answers than asking for the survey to be completed by the organisations themselves. We also conducted a shorter survey with the Finance Directors of 12 of the 14 central government departments and all of the 16 sponsored bodies. The two surveys gave us both quantitative as well as qualitative data.

6 We chose the 14 government departments to give us the most cost-effective coverage of government cash expenditure. In 2007-08, they collectively received over 94 per cent of the cash received from Parliament. We used a purposive sample of 16 public sector organisations based on discussions with departments and with the National Audit Office's financial auditors, who had direct knowledge of their cash management and banking arrangements (**Figure 16**). We selected them based on certain criteria, such as the size of cash holdings, existing good or bad practices and unique funding arrangements. This allowed us to review a wide variety of organisations and circumstances, but because it was not a random sample, it is not possible to extrapolate the findings across the whole public sector.

Figure 16
The 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: • 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).

Source: National Audit Office

7 Bodies in the health and education sectors are independent but they do receive funding from central government. We therefore conducted a high level review of guidance and advice issued by Monitor and the Higher Education Funding Council for England. Representatives of both organisations also provided us with answers to some specific questions and we visited the University of Warwick to improve our understanding of the processes and challenges faced by these independent bodies.

Analysis of data from departments and public sector organisations

8 We requested data relating to cash management and banking for all 30 organisations in our sample in order to compare performance and identify areas for improvement. The key quantitative data we analysed were:

- daily commercial bank balances;
- commercial bank charges and interest rates;
- the timeliness of invoice payments; and
- the variety of payment methods used.

9 The sources of qualitative data were:

- Board reports;
- risk registers; and
- internal audit reports.

We used this data to understand how cash management and banking is reported and managed within organisations. Where appropriate we identified specific examples of good practice or areas for improvement.

Analysis of HM Treasury data on the Cash Flow Management Scheme

10 We analysed data collected by the Treasury for its Cash Flow Management Scheme. We mapped the trends in departments' cash expenditure and forecast accuracy for the five years between 2004-05 and 2008-09 in order to assess whether there were any peaks or troughs in the demand for cash, and whether forecast accuracy has improved.

Semi-structured interviews with key central government bodies

11 We conducted interviews with HM Treasury's Exchequer Funds and Accounts team to understand their role in setting the policy for cash management and banking, how they designed and implemented the Cash Flow Management Scheme, and how they liaise with the Debt Management Office regarding forecast and actual cash flows.

12 Discussions with the Debt Management Office enabled us to understand how it uses the information it receives from the Treasury when interacting with the money market, and the value for money implications of poor cash flow forecasting.

13 Through meeting staff from the Government Banking Service we gained an understanding of how it monitors cash flows in and out of the Exchequer, as well as its role as the shared banking service provider for the public sector.

Review of international systems

14 We commissioned FTI, a specialist treasury consultancy, to review the cash management and banking procedures in three countries to compare and contrast arrangements and identify potential good practices that may be applicable in the United Kingdom. Canada has recently made significant changes, in particular with respect to centralisation of banking services; Denmark has a high level of electronic banking interaction with its citizens and companies and South Africa has recently made changes to its Exchequer system. The FTI consultants also reviewed international guidelines for good cash management and banking practices which we used to develop some general principles.

Other visits

15 We attended three events related to cash management and banking:

- the Treasury's annual cash management seminar, which is aimed at all public sector staff involved in cash forecasting and management;
- a user group meeting to discuss the practical implications of the newly created Government Banking Service; and
- a strategy day hosted by the Government Banking Service to seek people's input on how it should be operating by 2017.

16 To gain an insight into cash management processes in the private sector we met with staff from National Grid plc. We were interested in its arrangements as the company is of comparable size to a government department and has some similarities with regards to cash flows due to its operating model.

Appendix Three

Principles of good cash management

1 FTI, a specialist treasury consultancy we commissioned to review cash management and banking procedures around the world, found that there are no universally accepted best practice or technical guidance statements for cash management in the public or private sectors, but relevant material is produced by the Government Finance Officers Association of Canada and the United States of America and the International Group of Treasury Associations. The Chartered Institute of Public Finance and Accountancy has issued a guidance for a number of different types of public sector organisation, but the staff we surveyed did not mention that they made use of it in their day to day management of government cash.

2 The principles outlined below on the key elements of treasury management for government organisations are based on our review of the most relevant pieces of guidance. Many of the principles are contained within the Treasury document "Managing Public Money", which is the primary source of guidance on managing resources for public sector organisations in the United Kingdom. This Appendix should only be used as additional help and guidance to support it.

Overall arrangements for cash management

3 The organisation should have a formally approved cash management policy, which at least documents delegation of responsibilities and procedures on preparation of cash flow information and use of bank accounts. Where investment of surplus funds is permitted, the policy could cover topics such as: the objective for treasury management and the approach to risk versus return; monthly liquidity requirements; and a list of approved financial institutions and lending restrictions to each one.

4 The policy should be periodically re-assessed by appropriate senior staff.

Cash flow forecasting

5 The organisation should have adequate systems in place to ensure that all its significant cash flows are identified, and if needed prioritised, and reasonable predictions of planned expenditures are produced. This could be achieved by using historical data to measure activity of a cyclical nature, both for receipts and disbursements, and involving all business units in verifying, developing and monitoring cash flow forecasts. Such systems enable the cash forecaster to anticipate payments and receipts more accurately.

6 The organisation should determine the frequency with which cash forecasts are produced and how many of the subsequent weeks are covered; and whether projected flows are monitored against actual to assess the accuracy. Where surplus funds can be invested, it may be appropriate for monthly projections to be supplemented by weekly and daily forecasts.

7 Cash forecasters should recognise which items influence the organisation's cash level, and develop strategies that favour the collection of receipts as soon as possible, and the delay of payments as long as possible. Fixed items such as payroll, rent and outsourced contracts may need priority over discretionary expenditures that may not be as critical to the organisation or part of a fixed payment cycle. A forecast for payments should also recognise statutory regulations on prompt payment.

8 Forecasts should include room for error. Each organisation should determine this level of tolerance for itself.

Payment and collection processes

9 Debts need to be collected promptly and creditors paid in the most efficient manner when it is optimal to do so. To achieve this end the organisation should consider whether credit control activities, such as monitoring the level of debtors and the use of debt collection agencies, and using direct debit to improve the speed of funds clearing through banks are appropriate; and how frequent payment runs should be made and what the difference in timing of clearance with banks of the different payment methods means to cash held.

10 The organisation should evaluate opportunities for making and receiving electronic payments and receipts. In evaluating the costs and benefits of electronic payments, organisations should at least consider the following factors:

- bank fees;
- experience with fraudulent or returned cheques;
- implementation cost;
- administrative and processing costs;
- impact, either positive or negative, on the availability of funds and if applicable, interest earnings;
- information technology resources and capabilities;
- ability of the financial system to either generate or receive electronic transactions and track them; and
- statutory regulations.

11 The organisation should establish the appropriate authorising individuals for the implementation of electronic transactions and, to the extent that electronic transactions are used, financial controls to prevent fraud.

Procurement of banking services

12 Each organisation should formally define its banking requirements and evaluate the need against the costs and benefits of specific banking services, including but not limited to:

- reconciliation services;
- electronic-balance and transaction-reporting services;
- electronic payments;
- electronically transmitted analysis statements;
- overnight sweep accounts;
- credit-card receipt merchant services; and
- corporate cards.

It should also assess the relative benefits and costs of paying for services through direct fees, compensating balances, or a combination of the two.

13 The Treasury's policy is for all public bodies to bank with the Government Banking Service. However, where there is a need for procuring major commercial banking services, the organisation should periodically initiate competitive-bidding and negotiation processes, in accordance with laws and regulations. At the very least organisations should undertake market testing every five years to assess whether contracts continue to provide value for money.

14 Contracts for banking services should specify services, fees, and other components of cost. These should be monitored at least annually and organisations should consider defining performance indicators to measure the quality of customer service received.

15 The organisation should maintain the minimum number of bank accounts that enable it to operate efficiently and effectively. There should be strict controls on the establishment of new bank accounts.

Investments

16 Cash flow projections must clearly identify surplus funds and the period for which they are available for investment. If long-term investments are possible, organisations should have a strategy covering, for example, the objective; targets for the rate of return and measures to assess performance; risk and exposure parameters; the use of external fund managers; legal issues; and delegation, review and reporting arrangements.

17 Accurate and up to date information should be provided to senior staff so that appropriate decisions can be made on the investment of surplus funds. Reports could include an analysis of interest rates being achieved by different financial institutions and the cost of the transactions to invest short-term funds and managing them against the additional interest earned.

18 The organisation should asses the extent to which staff are suitably qualified or experienced to invest cash, and consider whether they receive appropriate training.

Appendix Four

Overview of cash management and banking arrangements

1 Parliament votes on how much each department is allowed to spend. The Treasury expects departments to draw down their funds to their Exchequer accounts on a monthly basis, rather than in one lump sum, to encourage better financial planning and management. So at the end of each month, all departments forecast their expenditure for the following month and send a request to the Comptroller of the National Audit Office. The National Audit Office's Exchequer section and the Treasury check that such requests do not exceed each individual department's voted allowance, and approves the transfer of funds. This transfer is simply a ledger entry in the department's Exchequer account to show how much cash is available to spend, and so does not need actual cash to be made available. In theory, departments could draw down their entire allowance at the beginning of the year without any financial implication, but in practice this would be challenged and unlikely to be approved.

2 This Appendix sets out:

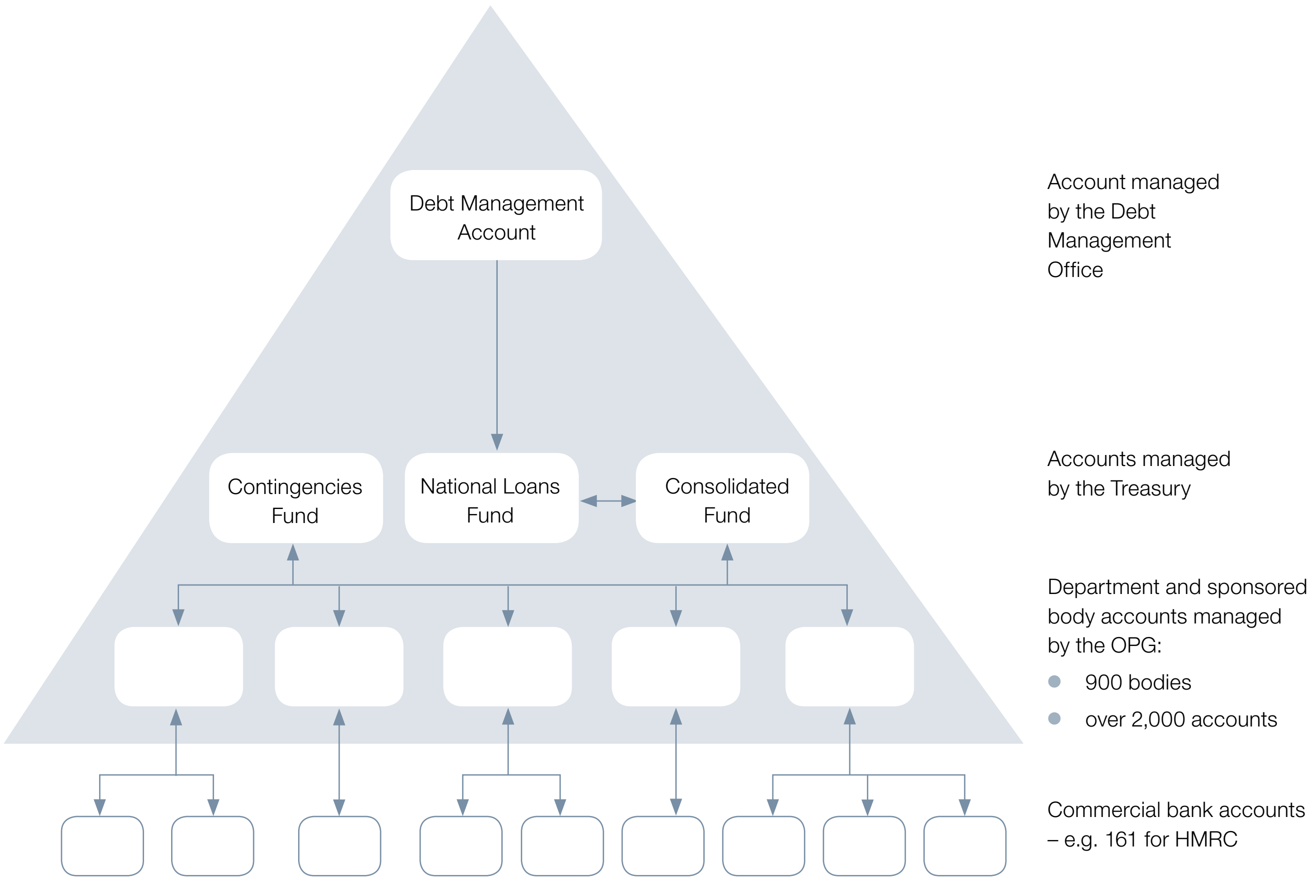
- how central government cash is managed through a mechanism known as the Exchequer Pyramid; and
- the interrelationships between the different central government organisations involved in cash management.

The Exchequer Pyramid

3 Government bank accounts at the Bank of England are linked together in a system known as the Exchequer Pyramid (**Figure 17**). The Consolidated Fund acts as the government's current account. The National Loans Fund is the government's borrowing and lending account, financing the needs of the government to the extent that taxation and other receipts are insufficient. The Contingencies Fund operates to make advances to departments if, for example, they have been given a new objective but Parliamentary authority is being sought but has not been granted. Below the main central accounts are the primary departmental and other public body accounts. The balances and transactions in these accounts were managed by the Office of HM Paymaster General, on behalf of the public bodies, through outsourcing arrangements with the Bank of England and Paymaster (1836) Ltd. Paymaster in turn has contracts with Royal Bank of Scotland Group plc, Citibank and Alliance & Leicester plc to provide some of its services.

The Office of HM Paymaster General is now incorporated within the Government Banking Service (see paragraph 13), which has let new contracts for the banking transactions and account management functions.

Figure 17
The Exchequer Pyramid



Source: National Audit Office

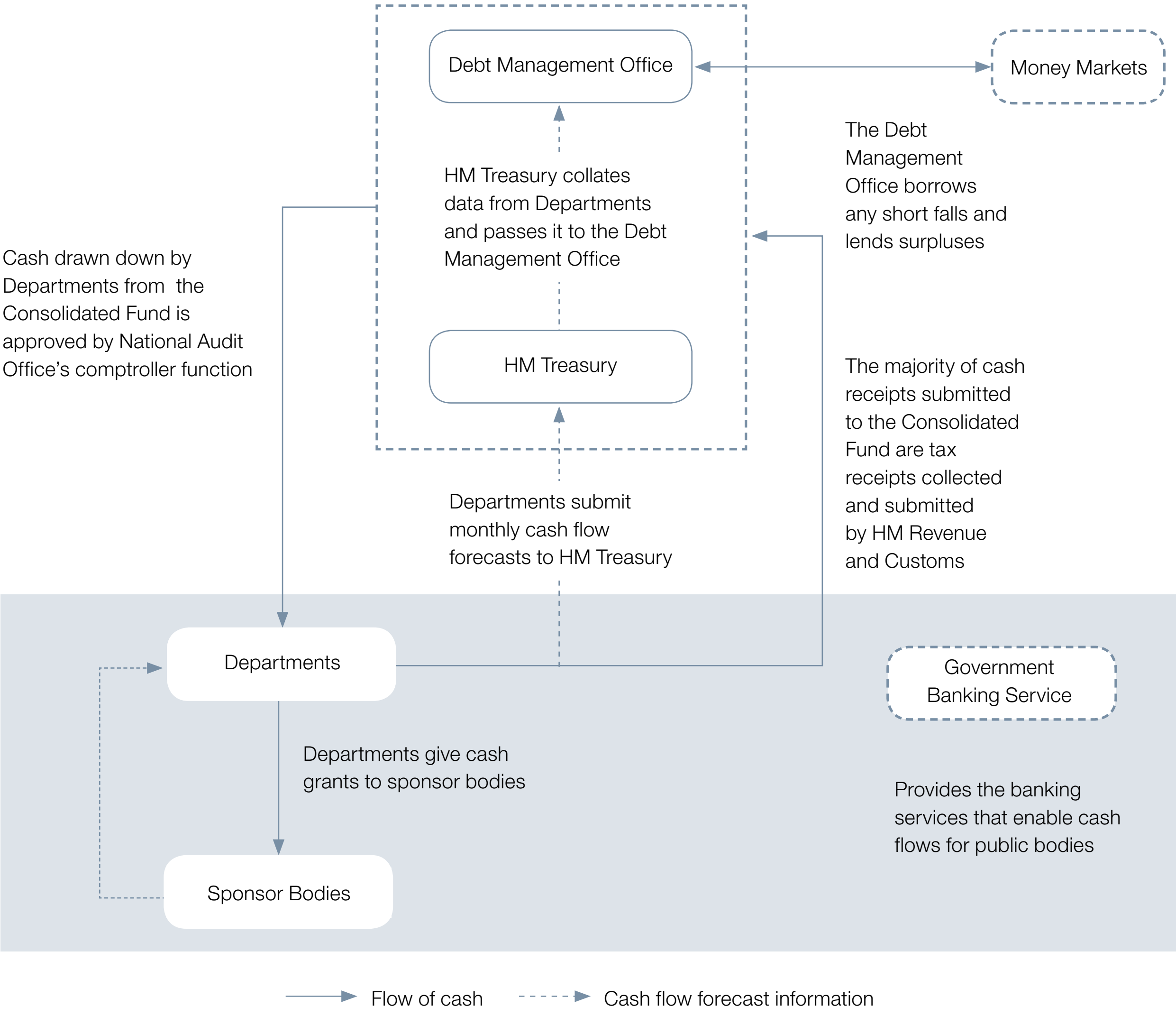
4 At the end of each working day, any public funds in the Exchequer Pyramid at the Bank of England are swept up to the National Loans Fund, which itself is swept into the Debt Management Account. The Debt Management Office has an agreement with the Bank of England for it to hold a certain cash balance every night to offset any late or unexpected outflows. If it exceeds the targeted balance then the Debt Management Office invests the surplus until it is needed; if it is short of the target it borrows the shortfall through the overnight or longer term money markets. If public bodies do not minimise the balances in their own accounts with commercial banks and place funds in their Exchequer accounts, the amount of net government borrowing outstanding on any given day will be appreciably higher, adding to interest costs and making the fiscal position worse.

The interrelationship of bodies involved in cash management

5 There are a number of bodies within the Exchequer Pyramid that manage cash flow for government (**Figure 18**).

Figure 18

Significant forecast information and cash flows which pass between public bodies



Source: National Audit Office

Role of the Treasury

6 The Treasury sets the overarching policy for how public sector bodies manage their funds, including their cash. It publishes the guiding principles in *Managing Public Money*.[25]

7 The Debt Management Office is an Executive Agency of the Treasury. Forecast data from all central government departments is collected and collated by the Treasury and then it submits it to the Debt Management Office. The Treasury also liaises with departments about any changes to the forecasts. On each working day, the Treasury's Swing branch monitors actual receipts and expenditure through the Government Banking Service accounts, and provides seven daily updates to the Debt Management Office with the latest expected net cash flow position for the end of the day. The Debt Management Office uses this information to adjust its borrowing and lending activities so that at the close of business it holds the targeted balance with the Bank of England.

Role of the Debt Management Office

8 When government spends more money than it earns, it needs to borrow the difference. On some days however, cash receipts from personal and business tax payments may be greater than expenditure. The Debt Management Office is responsible both for managing the longer term government borrowing, as well as the daily cash surpluses and deficits.

9 In May 2006, Bank of England money market reforms led to a move away from targeting a fixed daily balance in the Debt Management Account to targeting a weekly average balance. This means that the Debt Management Office now needs to specify a cumulative balance that it targets for each week. If it fails to meet this target, it will make it more difficult for the Bank of England to manage the overall cash balances, and so its ability to influence interest rates, in the sterling money market. As a result the Debt Management Office needs to know for each day whether it expects to have a cash surplus or a deficit so that it can arrange to either borrow or lend money.

10 To get the best value for money from its borrowing and lending activities, and to avoid large last-minute transactions which could be at poor rates, the Debt Management Office needs reliable cash flow forecasts. Once it receives the first forecast from the Treasury for a certain day, usually around 19 weeks in advance, it can begin to plan funding or investing the forecast net cash position steadily. Funding or investing steadily over time helps to minimise the potential impact on market rates of large daily inflows or outflows. If, for example, on a given day the Debt Management Office needs to raise money unexpectedly because a forecast was too low, it may need to borrow money back from the market which it has already lent out. Conversely, if it has raised surplus cash because a forecast was too high, it needs to lend back out the money it has already borrowed. This can incur transaction costs and potential losses if market interest rates have since moved.

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

Role of the Government Banking Service

11 In 2004 the Bank of England announced that it would stop providing retail banking services, and focus on its core purpose of maintaining monetary and fiscal stability by the end of 2009. The Treasury therefore established the Government Banking Programme to manage the changes. In 2006 it transferred the Office of HM Paymaster General and the responsibility for the Project over to HM Revenue and Customs.

12 The initial objectives of the Programme were to develop a common shared service for banking to meet the needs of HM Revenue and Customs and National Savings and Investments and the customers of the existing shared service provided by the Office of HM Paymaster General. As part of this exercise the Office of HM Paymaster General's back office function contract was to be re-tendered and HM Revenue and Customs' was to review its banking practices, such as cheque processing. In the longer term the new shared service agency was expected to take on the role of representing government banking in the wider payments industry and in the long-term to become the provider of choice for the public sector.

13 The Government Banking Service was launched in May 2008. It incorporates the Office of HM Paymaster General and is the new banking shared service provider for the public sector. The contracts it has let with the Royal Bank of Scotland and Citibank have replaced the seven banking providers previously used by HM Revenue and Customs and National Savings and Investments. The banking services covered by the contracts include all transactions and account management functions, but the money itself remains with the Bank of England and therefore inside the Exchequer Pyramid. The new arrangements with the commercial banks also mean there is no need to re-tender for back office services, with public bodies being able to interact directly with the banks on-line.

14 Other governments have undertaken more comprehensive banking programmes. For example the Canadian Receiver General's Department has centralised most of its banking operations for federal bodies into a single in-house operation because of the:

- economies of scale in procurement and processing;
- ability to implement change quickly and avoid duplication of investment;
- opportunity for a more consistent approach to reducing paper transactions and increase the availability of electronic payment services, including a single online payments engine;

- increased leverage to negotiate with banks and payment service providers for investment in services with better functionality because of the large volume of transactions;
- potential to use scarce expertise better; and
- capability for a single bank account infrastructure with simplified reporting of cash flows.

15 The Canadian experience suggests there are likely to be benefits to greater centralisation. The Government Banking Service is currently piloting its new arrangements, but departments we surveyed have identified a number of potential risks with the move of their main accounts over to the Government Banking Service:

- High costs and service disruption when migrating from one banking system to another;
- Lost revenue due to confusion on the part of customers over the numerous new bank account details; and
- Inefficiencies due to having to manage two different banking providers, as both Royal Bank of Scotland and Citibank will provide services to every customer.

16 The Government Banking Service will need to address these perceived risks and disadvantages identified by staff in organisations in the wider public sector before approaching potential new customers.

Appendix Five

Departments' cash flow forecast accuracy

1 As part of its Cash Flow Management Scheme the Treasury measures how accurately departments forecast their cash flow. This table shows the average percentage variance for each department's monthly forecast for the last five years.

Department	2004-05 %	2005-06 %	2006-07 %	2007-08 %	2008-09 %
Business, Enterprise and Regulatory Reform	44.4	22.3	26.9	24.2	4.3
Communities and Local Government	8.7	8.6	8.8	9.4	7.3
Culture, Media and Sport	2.8	0.4	1.3	0.7	1.2
Children, Schools and Families/ Innovation, Universities and Skills[1]	5.4	5.5	1.8	2.7	4.4/10.8
Environment Food and Rural Affairs	9.8	11.1	16.2	12.4	12.5
Health	5.1	5.6	15.1	7.9	7.2
HM Revenue and Customs	3.3	3.6	5.1	4.0	2.2
Home Office	12.3	22.5	16.4	11.6	17.4
International Development	31.4	11.9	5.7	23.9	28.6
Ministry of Defence	5.7	4.8	5.4	5.0	9.8
Ministry of Justice	9.7	7.0	6.8	4.0	5.7
Transport	7.1	8.5	5.2	5.3	3.5
Work and Pensions	5.0	1.6	2.5	1.3	1.6

Source: HM Treasury

NOTE

The Department for Children, Schools and Families manages the cash flow both for itself and for the Department for Innovation, Universities and Skills. Their forecast accuracy was calculated separately for the first time in 2008-09.

Appendix Six

Cash management in the health and education sectors

1 Bodies such as NHS Foundation Trusts and Higher Education Institutions are statutorily independent of government, but receive government funding. NHS Foundation Trusts' income is largely made up of payments for a contracted level of completed treatments and services, with a capped amount of income from private patients.[26] Given the greater independence of NHS Foundation Trusts, they must meet additional working capital requirements from commercial providers, whereas regular NHS trusts may apply for loans from the Department of Health. Higher Education Institutions receive funding from a range of sources, both public and private. On average around 55 per cent of university income is from public sector sources, the majority of which is in the form of teaching, research and non-recurrent grants from the Higher Education Funding Council for England.

2 This Appendix outlines the high level oversight of cash management and banking in NHS Foundation Trusts and universities undertaken by the relevant publicly funded bodies:

- Monitor, which is responsible for:
  - determining whether or not Trusts are ready to become an NHS Foundation Trust;
  - ensuring that NHS Foundation Trusts comply with the conditions they have signed up to (Terms of Authorisation), they are well led and financially robust; and
  - supporting NHS Foundation Trust development
- The Higher Education Funding Council for England, which is responsible for:
  - distributing public money to higher education institutions in England;
  - that the cash is used as Parliament intended; and
  - monitoring the financial health of Higher Education Institutions, ensuring any necessary corrective actions are taken.

26 The exception is NHS Foundation Mental Health Trusts which have three year block contracts in place, the funding of which is renegotiated annually.

NHS Foundation Trusts

Cash flow

3 To be granted NHS Foundation Trust status, NHS Trusts must demonstrate that they are financially viable, legally constituted and well governed. As part of assessing whether or not a Trust is well governed, Monitor will review the information the Trust presents to its Board, including what cash flow and working capital forecasting occurs in the Finance Department.

4 On an annual basis, NHS Foundation Trusts submit a three year Business Plan to Monitor, which includes a cash flow forecast. Monitor reviews the business plan and issues a financial risk rating for each Trust, indicating the level of risk associated with the plan, and in particular with regard to a potential breach of Authorisation. Monitor will then review the Trust performance against the plan on a quarterly basis. Where there is a risk to the delivery of the plan or the financial stability of the organisation, Monitor may require more detailed financial information, such as weekly cash flow forecasts.

5 The metrics that Monitor uses to assess the level of financial risk for an NHS Foundation Trust includes a liquidity ratio. In calculating the liquidity ratio NHS Foundation Trusts can include up to 30 days of a working capital facility in the calculation. However, it is for the Board of an NHS Foundation Trust to determine what level of working capital facility is required from an operational risk perspective, and what cash management strategy the Trust should implement. In some cases this means holding cash of more than 30 days' working capital.

6 There are no formal incentives for good cash management in NHS Foundation Trusts. The Terms of Authorisation require that each Trust operates in an efficient, effective and economical manner, and Board members determine the level of attention on cash management. Monitor's 'Compliance Framework', the freedom to retain surpluses and borrow commercially, and Boards' focus on the topic has increased the attention on financial management across the Foundation Trust sector. Media and Parliamentary attention on banking has already prompted some NHS Foundation Trusts to elevate it up the agenda. In future, as the government's fiscal position tightens, cash management may need to be of a higher priority.

7 As with all public sector organisations, performance against the prompt payment target must be reported in each NHS Foundation Trust's annual report and accounts. Following the announcement of the ten day target, Monitor wrote to all NHS Foundation Trusts advising them of the announcements and encouraging them to pay suppliers within ten days

Banking

8 NHS Foundation Trusts may have working capital facilities with commercial banks. At 31 March 2009, they held around £2.8 billion in cash, around £2.4 billion of which was deposited with the Exchequer. In light of recent events, Monitor believes it is likely that Trusts will continue to deposit a high proportion of their cash with the Exchequer, because it is low risk and earns interest. To date NHS Foundation Trusts have benefited from holding their cash on deposit with both commercial organisations and the Exchequer.

9 Around 60 per cent of the £2.8 billion cash balances are held in just 30 per cent of NHS Foundation Trusts. The build up of cash across the NHS Foundation Trust sector reflects their ability to retain and reinvest surpluses. The majority of NHS Foundation Trusts have plans to reinvest their surpluses in capital projects over the next five to ten years, with around £1.1 billion million already earmarked for non-maintenance related projects in 2009-10.

10 Legislation requires Monitor to set a limit on the amount each NHS Foundation Trust is allowed to borrow. The total amount all NHS Foundation Trusts were permitted to borrow at 31 March 2009 is £6.3 billion, but the actual take up of loans at that date was around £0.3 billion, all of this from the Department of Health's financing facility.

11 Following the banking crisis and a review of its best practice advice, Monitor has not changed its advice and guidance on banking arrangements. NHS Foundation Trusts must notify Monitor of anything which threatens their financial stability, but Monitor specifically asked all NHS Foundation Trusts whether they had any cash invested in Icelandic banks to assess risk and exposure to their cash position. Two Trusts had invested around £1 million each. The Department of Health subsequently made a request to Monitor about the sector's exposure.

12 NHS Foundation Trusts report to Parliament through Monitor, and so the Department of Health receives less detailed information than from other sectors of the NHS. Given that Foundation Trust spending is counted against the Department of Health's expenditure limits set by Parliament, but are free to spend their budgets and surpluses at any time, there is a risk that the Department may exceed its expenditure limits. This is currently a particular risk given the cash surpluses they are holding.

Guidance

13 Monitor issues various forms of guidance, some of it mandatory, such as the 'Financial Reporting Manual'. The best practice advice in 'Managing Operating Cash' is aimed at Boards. It focuses on cash that NHS Foundation Trusts are likely to need within the next 12 months for operational purposes, and advises them how to invest it in a way that earns a competitive rate of return while minimising risk and keeping it readily available. It also specifically advises NHS Foundation Trusts to have a written policy, which may set treasury management objectives, clarify the organisation's attitude to risk, and identify the necessary controls.

Higher Education Institutions

Cash flow

14 The Higher Education Funding Council for England publishes its Financial Memorandum with Higher Education Institutions, which sets out the terms and conditions for payment of government funded grants. The size of the teaching grant is primarily based on current year forecast student numbers, which is subsequently adjusted to incorporate actual numbers. There are a number of circumstances under which the Council adjusts grants in response to changes in student numbers. The Council may, but historically has not, charged interest on grant repayments.

15 Higher education institutions demonstrate the fulfilment of their obligations, including the proper use of funds, by submitting accountability returns to the Council. Returns include financial statements and financial forecasts, along with a commentary on past performance and future prospects, and internal and external audit documents. The Council's staff assess the level of risk to each of the institutions from these documents and agree appropriate remedial action for any rated 'at higher risk'

16 Typically the core grant is paid in ten approximately equal monthly instalments, avoiding February and March when institutions historically received the payments for tuition fees from the Student Loans Company. This was to provide an even flow of cash over the year, taking grant and fees into account, and avoid the risk of funding institutions in advance of their need to spend money, which is not allowed.

17 The Council has found that the levels of underspend on government funding have improved. In 2006-07 it examined seven programmes which had been allocated £343 million of the £6.7 billion allocated by government, and found that the level of underspending was about £31 million, or nine per cent of the allocations examined. It believes that expenditure in 2008-09 will require individual institutions to closely manage their cash flows and net liquidity, which at £3.4 billion was equivalent to 74 days' expenditure, but is forecast to fall to 55 days by 2010-11.

18 Institutions' internal financial forecasts tend to be prudent about funding beyond the current spending review[27] period, and so understate required capital expenditure. With predictions that the level of borrowings will continue to rise, and the resultant increase in interest and capital payments, they may need to improve the accuracy of their cash projections to ensure projects remain affordable.

27 Spending reviews set out departments' budgets for the following three years, and the outcomes to be achieved.

Banking

19 Higher education institutions use commercial banks. They can, and indeed are expected to, earn interest on their cash balances. Operating surpluses in the sector totalled £165 million in 2007. Most institutions have other cash reserves, and so significant amounts of funds are on deposit with banks, which are likely to have lower levels of return. Higher education institutions have the right to enter financing arrangements, but they must get approval from the Council for new long-term financial commitments that meet certain criteria.[28] Interest payments on borrowings will potentially be less in the current economic climate, but these reductions are unlikely to match the loss of earned interest, and so the Council believes that institutions may adopt a more risk-averse approach to both investments and borrowing.

20 The Council considered institutions' financial exposure following the banking crisis through its normal engagement and risk monitoring processes. It also surveyed the sector to confirm the level of funds invested in Icelandic banks. The implications of the economic conditions have been reflected in the Council's assessment of risk to institutions, particularly with regard to short-term cash flow.

Guidance

21 Relevant guidance issued by the Council covers effective financial management and borrowing, and has been developed in collaboration with the Higher Education sector. It is not usually mandatory and is often based on the findings from surveys with all, or a sample of, the institutions. In 1996 the Council published a Value for Money National Report with an accompanying Guide to emphasise the need for effective treasury management, and to act as a catalyst and aid institutions in undertaking reviews of their cash and banking arrangements. The examples of good practice and areas for improvement identified are still pertinent, and the recommendations on how processes and policies could be enhanced are applicable today.

28 Either where the servicing cost is above four per cent of total income or the cash book deficit exceeds five per cent of total income for more than 35 consecutive days.

Appendix Seven

International government comparisons

1 Governments around the world need to manage their cash flow, but the processes they adopt and the banking arrangements they use vary considerably. The Government Finance Officers Association of Canada and the United States of America and the International Group of Treasury Associations have highlighted some common processes within countries they deemed to have efficient cash management structures. These include:

- a bank account structure which has at its centre a single main Government bank account held at the national bank;
- an automated sweep system to pool cash and reduce the level of idle balances;
- a structured and effective cash flow forecasting system and process;
- fewer different business resource planning systems used at government department level to allow more information technology integration and more effective flow of information; and
- centralised and highly automated payment and collection processes with increasing use of electronic payments.

2 This Appendix summarises the key features of the cash flow management and banking arrangements of three foreign governments:

- Canada, because it has mandated the use of government banking services for all central government bodies;
- Denmark, because it has implemented widespread use of electronic banking; and
- South Africa, because it has recently undergone changes to its banking services.

Canada

3 The Canadian government holds accounts with all 15 domestic clearing banks, which reduces its exposure to credit and operational risks. The government has also fixed the fees the banks charge public bodies for standard banking transactions, such as electronic and cheque payments, as part of a Memorandum of Understanding that is renegotiated every three years.

4 All 7,500 accounts are linked to 53 'concentrator' accounts, which are also with the clearing banks, and are in turn linked to the central Consolidated Revenue Fund account with the Bank of Canada. Each day at 3pm, the net balances in the concentrator accounts are swept into the Consolidated Revenue Fund.

5 The government has approved the use of six different information technology systems for creating and authorising payment files, which has reduced the number of systems used from 70. Approximately 70 per cent of payments are made electronically, with the remainder made by cheque.

6 Government departments are responsible for managing banking arrangements and negotiating banking services which do not involve inflows and outflows in the central account at the Bank of Canada, such as day to day expense accounts.

7 Independent public bodies, such as regional bodies in the Canadian Provinces, are highly autonomous and manage their funds independently of the federal government.

Denmark

8 The Danish Government uses just one commercial bank, Danske Bank, to manage its accounts and transactions. The bank account structure ensures that the balances of all 180 departments and agencies are consolidated via an automated sweep into a single account held with the National Bank of Denmark. The real time sweep, which happens throughout the day, creates either a credit or debit balance between the relevant department/agency and the central cash management function of the state. Interest is paid on the balances in the National Bank of Denmark in an effort to ensure that best cash management practices are implemented by government organisations.

9 Each of the 180 departments and agencies holds around six accounts with Danske Bank. Each of these accounts has a specified use, such as salary payments or revenue collection, to simplify the reconciliation process.

10 There is one business planning resource system that is used by each of the 180 departments and agencies. All payments are generated within the department or agency through this common system.

11 All public sector institutions in Denmark only accept invoices in electronic format. Approximately 1.25 million invoices are processed a month and they are paid electronically to the individual or company's designated account for government business.

12 Public bodies which are independent of central government, for example universities, schools and museums, must also open an account within the central banking structure at Danske Bank. Any state funding that these institutions receive is paid into this account. The bodies are permitted to move cash to a bank account outside the Danske Bank central pooling structure. However, the government pays independent bodies interest on cash balances to incentivise them to keep their money within the central banking structure. Interest is set at predefined rates for these bodies and is funded from the overall interest that is earned by the government account at the National Bank.

South Africa

13 The South African Reserve Bank is both the central bank and the transactional banker to the government. There is a high level central funding and investment account into which all other government balances are swept on a daily basis. Each of the 25 government departments holds an account with the South African Reserve Bank. This structure facilitates the management of government owned cash balances and automates the funding and investment process.

14 Each department has a designated payment agency to process its payments. Generally all payments over 2,000 South African Rand (approximately £140)[29] have to be made by electronic means, and so virtually all payments are made in this way.

15 The largest clearing banks (First National Bank, ABSA, Standard Bank, and Nedbank) are recognised as having systemic importance to the South African economy, and so departments are only allowed to procure commercial banking services from one of these four. Tax revenues are also collected through these four banks and receipts are swept into the central account at the South African Reserve Bank on a daily basis.

16 Independent public sector bodies and state owned entities cannot open bank accounts without the approval of the South African National Treasury. The commercial banks are aware of this requirement and help to enforce it.

29 Calculated using the average exchange rate for 2007-08 published by HM Revenue and Customs.

Appendix Eight

Assessment of incentive mechanisms

1 We reviewed the Treasury's two formal incentive mechanisms – the Cash Flow Management Scheme and the annual cost of capital charge – against good practice criteria taken from a National Audit Office report: *"The use of sanctions and rewards in the public sector"*.

Criteria	Evidence and conclusions
1 Clearly define a measurable objective.	The overarching objective regarding cash management for public sector bodies, as set out in *Managing Public Money*, is to "minimise the balances in their own accounts with commercial banks". However, the Cash Flow Management Scheme only defines a measurable objective for the forecasting criteria. The cost of capital charge does address the issue of balances in commercial accounts, but it is a much weaker incentive mechanism as it is only measured on one day a year, and is not transparent in showing how well departments are performing.
2 Identify the activities and the outputs that are needed to achieve the objective.	Departments are expected to understand their business and to establish appropriate systems and processes. Given this flexibility, they vary in how they go about achieving the objective. The Treasury organises an annual seminar on cash management to promote best practice and facilitate the exchange of knowledge between departments. HM Treasury staff also visit departments to discuss their cash management processes with a view to helping them improve.
3 Identify and engage with the key stakeholders, map the performance levers and incentives in use.	The system of incentives was designed by the Treasury in consultation with departments and the Debt Management Office. The Treasury engages with these organisations on a daily basis and a letter is sent to Finance Directors of the large departments each year about the Cash Flow Forecasting Scheme and their performance on cash forecasting.
4 Use the delivery map to undertake a stakeholder analysis. Identify where the main barriers are, and the evidence on the effectiveness of the current programme, the performance levers, and their associated sanction or reward mechanisms.	No separate stakeholder analysis was undertaken, but the Treasury involved departments in the design of the Cash Flow Forecasting Scheme and amended it based on their feedback.

Criteria	Evidence and conclusions
5 Understand the full range of sanction or reward mechanisms available – financial, reputational and organisational.	The Treasury has used a combination of reputational and financial incentives: • League tables that rank departments' performance which are circulated monthly. • Notional charges based on the accuracy of forecasting of cash flow that are redistributed to all Departments in the form of more or less End Year Flexibility. • The notional cost of capital charge is applied to balances held at commercial banks but not to balances held at the Exchequer.
6 Assess the motivations of the key players. Assess the balance between financial and altruistic motivations, and whether they operate at organisational, team or individual level.	No formal assessment was carried out, but through the Treasury's interactions with departments continuous informal assessment takes place. From our discussions with departments, reputational incentives are more effective in motivating the cash managers. The financial incentives are perceived as too small to change behaviour, but are useful to illustrate the importance of good forecasting to non-finance staff, and therefore to improve their performance. From our survey, few departments use performance measures on cash management. Even where they do, they focus on the department's own performance rather than the benefit to the whole public sector.
7 Identify outcomes over which the players have control or significant influence.	The amount of influence departments have over cash flows in and out of the accounts on which their performance is measured varies. While departments do not have total control over receipts, some make more effort than others to discuss cash flows with their sponsored bodies. The amount of communication the cash managers had with their departmental colleagues making payments was also variable. Without dialogue control over payments is reduced. With respect to the cost of capital charge, organisations have significant control over the amount of money they hold at the Exchequer.

Criteria	Evidence and conclusions
8 Link the incentives to performance measures which lead to the desired (long-term) outcomes in a predictable way. A single measure may not capture the relevant aspects of performance, but any set of measures must be kept manageable.	The Cash Flow Management Scheme links a number of performance measures to incentives: • 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. These are clearly defined and measurable objectives and once the forecasts have been submitted to the Treasury, departments feel motivated to achieve them. While this supports the objective of providing the Debt Management Office with more accurate forecasts, it may not help to maximise the amount of cash held within the Exchequer. This illustrates the greater importance given to the Cash Flow Management Scheme as an incentive mechanism compared to the cost of capital charge.
9 Ensure the rewards and sanctions are cost-effective. Where they involve financial elements, it may be sensible to model the operation of the system to help define appropriate values or ranges.	Formal modelling has not been carried out, and may not be appropriate because they are not cash costs. Some public bodies say that the financial incentives have little or no impact, as they are currently not receiving End Year Flexibility. One aspect of the Treasury's Alignment Project is to replace the cost of capital charge with a more effective incentive to drive the right behaviour. Most departments believe the non-financial league tables provide the most motivation and are an appropriate form of incentive. They also require minimal resources in the form of one member of staff at the Treasury to collect, analyse and report the data.
10 Introduce safeguards to prevent unintended behaviours.	The Treasury use the following mechanisms to prevent unintended behaviours: • Guidance and annual letters sent to Finance Directors of large departments reminding them of the policy on keeping cash at the Exchequer, the importance of cash management and the need for accurate forecasts. • An annual review of departments' cash balances at commercial banks. The principles outlined in the key guidance document, *Managing Public Money*, are not strictly followed by organisations or enforced by the Treasury. Some organisations we surveyed were not aware that cash management was included.

Criteria	Evidence and conclusions
11 Develop and implement data systems that collect and analyse timely and reliable performance data.	The Treasury collects forecast data from all departments every month, and actual payment data from centralised payment systems. The data from the payment systems is subject to external audit.
12 Develop the expertise to apply the sanctions or rewards in a timely, consistent and transparent manner, especially when using complex contractual arrangements with delivery agents.	Some departments believe they are unfairly penalised for payments by their sponsored bodies which they are unable to forecast. The Treasury is prepared to be flexible in applying its incentives, and will consider valid reasons for departments missing a forecast. For example, if a policy decision that is outside of a department's control leads to a change in cash expenditure, it may decide an adjustment to the forecast accuracy calculation should be made. However, this flexibility is not always possible.
13 Build regular internal and external reviews of the effectiveness of the sanction or reward mechanism into the programme's overall performance management cycle.	The Cash Flow Management Scheme has not been formally reviewed, but the Treasury's Exchequer Funds and Accounts team review it on an on-going basis. For example, the scheme was extended in April 2006 to include BACS transactions.
14 Where possible, phase in new sanction or reward mechanisms gradually, or on a pilot basis, to identify and address any dysfunctional behaviour.	The Cash Flow Management Scheme was implemented after consultation. The Treasury is aware that, as with all incentive schemes, departments may on occasion behave dysfunctionally, and we have found a number of examples which provide poor value for money for the taxpayer: • Some departments pay their sponsored bodies by paying grants at the beginning of the year, quarter, or month, rather than when they are needed to cover actual liabilities. • If a payment is not required, some departments will use the cash for another invoice, in advance of the due date, to stick to its forecast. This helps to maintain forecast accuracy, but means money leaves the Exchequer earlier than necessary, increasing the cost of borrowing for government. However, we have no evidence to suggest that this is widespread, and now that invoices should be paid within 10 days, the financial impact of such a practice will be less.

Source: National Audit Office