National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 487
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HM Treasury

Progress in improving financial management in government

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HM Treasury

Progress in improving financial management in government

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

28 February 2011

The National Audit Office has examined the financial management of government departments for many years. In recent years we have reported specifically on financial management in individual departments, with six major departments covered since April 2009, and a further three reports due to be published by April 2011.

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Summary

The importance of financial management

1 Good financial management is at the heart of an effective, well-run organisation. Successful organisations demonstrate good financial management by understanding exactly how they are spending money and what return or policy outcomes they are getting for that money.

2 Good financial management supports sound decision-making, facilitates accountability, improves planning and subsequent refinement of these plans, and enables an organisation to devise its strategy and manage risks to its delivery. Failures in financial management reduce value for money, put at risk the achievement of an organisation's policy objectives, such as delivery of services to the public, and can result in additional costs in the long term.

3 Effective strategic financial management has never been more important than at the present time. The scale of cost reductions proposed in the public sector means that departments are looking beyond either reductions in discretionary spending or efficiencies in existing operations. They need to devise more radical plans to decrease costs sustainably over the longer term, while still delivering the new policy objectives.[a] As part of this, in the October 2010 Spending Review, the Government asked departments to identify their priorities, based on an accurate, realistic assessment of the costs, benefits and risks. To carry out this exercise effectively, and to build on it for future years, requires mature financial management.

a *A Short guide to Structured Cost Reduction*, National Audit Office, 2010.

The state of financial management in central government

4 The National Audit Office has examined the financial management of government departments for many years (**Figure 1**). In recent years we have reported specifically on financial management in individual departments, with six major departments covered since April 2009, and a further three reports due to be published by April 2011.

5 From this extensive body of work, we have developed a scale of maturity in financial management (**Figure 2** overleaf). Overall, we conclude that almost all government departments have achieved what we define as ‘core competence’ in financial management, with a central finance function which competently captures and reports the transactions and financial position of the organisation. They have sound financial controls and their annual accounts are materially accurate and prepared in reasonable time. However, active management of cash flows and the balance sheet remains generally inadequate across government.

Figure 1
National Audit Office coverage of financial management in government departments

Type of audit	Coverage of financial management	Number of audits
Audit of accounts of departments, and associated agencies, non-departmental public bodies, charities and companies.	As part of arriving at an opinion on the accounts, we examine key financial management systems, and will issue a Letter to Management recommending process and control improvements.	450 accounts each year.
Financial management reports.	Each one is a detailed review of the effectiveness of financial management in a single government department.	Around five each year.
Value for money audit.	Reports aim to establish whether the department has made optimal use of resources to achieve the intended outcomes. Aspects of effective financial management are always a part of this.	Around 60 reports each year.

Source: National Audit Office

Figure 2
What is meant by good financial management?

Maturity level[1]	At this level, we would see	This means the department can
Enterprise	The finance function acting as centre of excellence and enabler for the business. Financial information central to the Board's decision-making. A sophisticated understanding of key cost drivers and outcomes.	Anticipate and respond to changes in its environment. Identify savings continuously. Plan and deliver value for money outcomes.
Enhanced	The finance function involved in the most significant decisions at Board level. An understanding of the impact of change on cost and performance.	Respond to challenges in good time. Deliver cost efficiency savings when required. Deliver most activities to plan.
Core competence	A competent finance function, lacking a routine role in strategic decision-making. A basic level of competence in financial management and management accounting in the wider business.	Manage well when the environment is stable, but not anticipate challenges. Achieve cost reduction through a combination of efficiency programmes and crude budget cutting. Not always deliver activities to plan, because of difficulties anticipating and responding to risks.
Inadequate	A competent finance team without any wider influence in the business. Problems with timeliness and quality of financial data from across the business.	Become aware of potential overspends too late to be able to bring them back into line. React to reductions in funding by crude budget cutting only. Regularly miss time, cost and quality targets.

NOTE
1 This scale describes an overall view of financial management maturity, based on the cumulative levels set out in our published *Financial Management Maturity Model* which can be found at: http://www.nao.org.uk/help_for_public_services/financial_management/fmmm.aspx. The *Financial Management Maturity Model* is a more detailed framework which can be used for diagnostic and self-assessment purposes.

Source: National Audit Office

6 In our work we have seen examples of significant improvements made by departments in financial management (see 'Improved practice' examples 1 and 2 on pages 15 and 20). Some organisations, such as the Home Office, and the Foreign and Commonwealth Office, have improved notably in recent years and are showing elements of 'enhanced' practice, particularly in increasing the influence of finance on the organisation's overall strategic management. Nevertheless, we have seen no evidence of any central government department achieving 'enterprise' financial management capability. We define this as a state where the finance function acts as a major driver behind the performance of the organisation, providing sophisticated information for decision-making, and acting as a centre of excellence for financial management across the business.

Progress since the Committee's report in 2008

7 There have been important improvements in financial management since 2008, when the Committee of Public Accounts last reported on the subject.[b] The Treasury has driven increased finance professionalism – all Whitehall finance teams are now led by a qualified finance professional as Finance Director. All Whitehall departments also have a qualified finance professional on the Departmental Board, except the Department for Environment, Food and Rural Affairs. The number of financially qualified and experienced non-executive board members has also increased. The increased professionalism of finance leadership is underpinned by a programme of finance training for graduate recruits and an increase in professional staff in finance functions.

8 Departments all deliver accounts annually and do so before the Parliamentary Recess in July (of the major departments, only the Ministry of Justice failed to meet the summer 2010 recess deadline). The number of overall overspends against the amounts approved by Parliament is low.

9 The Treasury has agreed with Parliament that the framework of controls over public expenditure will be harmonised from 1 April 2011, so that the existing frameworks for Parliamentary Supply, Budgetary Controls and Resource Accounts are for the first time aligned in a single set of figures. From 2012, all government departments will report to the Treasury against a simplified, high-level chart of accounts, which will categorise spending in a more meaningful and consistent manner. These changes will help provide a clearer, single view of where money is allocated and spent, for managers, finance professionals, non-executives and others who hold departments to account. It has the potential to act as a driver for improved financial management in central government.

b Committee of Public Accounts, *Managing financial resources to deliver better public services*, HC519, Session 2007-08.

10 However, financial matters still do not have sufficient influence over strategic departmental decision-making. Whilst there has been some progress in departments understanding their costs, many do not understand fully the costs of their activities. It remains unusual for departments to have good information on the unit costs of outputs, measures of productivity or the value of outcomes, especially where outcomes cross departmental boundaries. Many strategies, business plans, resource allocations and performance reporting frameworks do not clearly link together. Without information on costs and benefits, departments do not have a sound basis for making fully informed choices about what activities to stop, to change, and to continue, as they were asked to do in the Spending Review.

11 Departments are generally weak at monitoring their overall financial position, including their balance sheets, and do not generally forecast cash flow in the medium term. If Boards were provided with data and trend information on items such as stock levels, debtors and creditors, investment in and depreciation of assets, at intervals appropriate to the nature of their business, they would be able to manage their resources effectively over the medium to longer term, and anticipate challenges that could affect service delivery.

12 We found Boards were not normally being presented with balance sheet information except for the purposes of approving the accounts. In general, departments fail to connect the strategic financial information, prepared for external reporting in the accounts, with the information that is used day-to-day for management purposes. Moreover, once budget settlements are agreed, departments generally focus on monitoring only against a one-year budget, with a few looking as far ahead as the current spending review period of four years.

Achieving greater maturity in financial management

13 The Government has committed itself to raising standards of financial discipline, as an integral part of getting the deficit under control. However, reaching what we have defined as 'enterprise' financial management requires significant change across the civil service, to a state where:

- the civil service culture expects decisions to be made on the basis of good information, with confidence in the understanding of the financial consequences;
- departments identify savings as part of routine business, and the way that staff are assessed and rewarded helps incentivise them to seek sustainable cost reductions and pursue value for money; and
- all senior civil servants demonstrate a good level of expertise with financial information and concepts.

14 We consider that achieving this transformation in financial management requires explicit change programmes in government departments, and there are some central enabling steps needed to ensure these programmes are successful. The Treasury has recognised this challenge with the publication of *Managing taxpayers' money wisely: commitment to action*, in January 2011, in which it set out actions designed to drive progress in the above areas from the centre of government. It has also stated that it will require all departments to institute financial management improvement plans and report on these regularly. We welcome these commitments and consider that they have the potential to contribute to fundamental change. Our recommendations suggest further enabling actions that should be taken now.

Recommendations

On vision and communication:

a **The most senior leaders in Whitehall have not demonstrated clearly the importance of good financial management and their commitment to it.** Accounting Officers should:

- consistently demonstrate through their leadership of departments their commitment to a clear vision incorporating what we have described as 'enterprise' financial management; and

- ensure that professionally qualified Finance Directors are involved in all aspects of Board-level decision-making, and influence decision-making throughout departments.

b **The centre of government has not empowered its core expertise in financial management with the strategic influence to achieve fundamental improvements in financial management maturity.**

- In developing further the capacity of the government's 'corporate centre', as set out in *Managing taxpayers' money wisely*, the Treasury and Cabinet Office should strategically position their financial management expertise to influence and communicate the vision set out in that document, and to publicise good practice examples and the value for money benefits to be gained.

- The Treasury should continuously reinforce the key messages, through their Spending Teams' work with departments.

On removing obstacles:

c **The overriding incentive for departments to meet annual expenditure limits set by the Treasury, coupled with lack of flexibility to move spending between years and between categories of spend, can lead to poor financial management decisions that reduce value for money.** We recognise the importance of in-year control in the current fiscal climate. Against this background, the Treasury should encourage flexible resource planning, and consider how to enable movement of resources between Departmental Expenditure Limits and Annually Managed Expenditure, and between years, where this improves value for money without jeopardising overall in-year spending control.

d **While there has been progress since 2008, there is scope for further improvement in financial data presented to departmental Boards to inform decision-making. The monitoring of balance sheet information is particularly weak.** Accounting Officers should work with new departmental Boards and Finance Directors to drive improvements to the timeliness, clarity, quality and utility of financial management information, learning from good practice where it exists – this should not usually require major new IT systems.

On institutionalising change:

e **The importance and principles of good financial management are not embedded in the culture of the civil service, and hence there are inadequate incentives for managers and staff.** The Cabinet Office and Treasury should review policy on recruitment, promotion, training and performance management and reward systems, which departments should then implement, to make financial management responsibilities central to all aspects of civil service thinking.

Part One

Financial management in government today

1.1 HM Treasury Group's Departmental Strategic Objectives for 2008-11 included the objective to 'bring about a step change in the finance … functions in government'. In 2008, the Committee of Public Accounts (the Committee) reported that there was some way to go before financial management was an integral part of departmental cultures, and was given the necessary priority to ensure services could be delivered efficiently and cost-effectively.[1]

1.2 This part of the report reviews the evidence of progress in financial management since 2008, using our maturity scale (Figure 2 on page 6). We draw on evidence from our financial audit of accounts, financial management reviews and value for money reports.

Progress since 2008

1.3 There have been some important improvements since 2008. Our financial audit work has noted that the increase in numbers of professionally qualified finance staff has improved the standard of the finance function, and in many departments the finance function is increasingly at the heart of decision-making. In 2009, the Cabinet Office reported that 'Departments have demonstrated improvements to financial management capability'.[2] In the first round of Capability Reviews in 2006-07, eight departments had been considered weak and given an amber/red rating for their ability to 'plan, resource and prioritise'. One department, the Home Office, was assessed as a serious concern (red rating). By 2008-09, only the Ministry of Justice was rated amber/red and all other departments were either amber or green (**Figure 3** overleaf).

1.4 Since 2008, the number of finance professionals on departmental Boards has increased markedly, in a recruitment drive spearheaded by the Treasury. All departments have a qualified finance director and all, except the Department for Environment, Food and Rural Affairs, have a qualified finance professional sitting on the Board. There has also been further recruitment of senior non-executives with financial expertise. All 17 major government departments have a non-executive chairing the departmental audit committee and 12 of these are qualified accountants, while the rest have relevant skills and the support of other financially qualified non-executives.

Figure 3

Findings of Cabinet Office Capability Reviews on departments' ability to plan, resource and prioritise

	2006-07	2008-09
Department for Constitutional Affairs	Urgent development area	1
Department for Work and Pensions	Urgent development area	Development area
Department for Education[2]	Development area	Well placed
Home Office	Serious concerns	Development area
Department for Business, Innovation and Skills	Well placed	Well placed
Cabinet Office	Urgent development area	Development area
Department for Communities and Local Government	Development area	Development area
Department for Culture, Media and Sport	Well placed	Well placed
Department for Environment, Food and Rural Affairs	Urgent development area	Well placed
Department for International Development	Urgent development area	Development area
Foreign and Commonwealth Office	Urgent development area	Development area
Ministry of Defence	Development area	Development area
Crown Prosecution Service	Well placed	Well placed
Department for Transport	Well placed	Well placed
Department of Health	Well placed	Strong
HM Revenue & Customs	Well placed	Well placed
HM Treasury	Well placed	Well placed
Ministry of Justice[3]	Urgent development area	Urgent development area
Department for Innovation, Universities and Skills	Development area	Development area
Government Communications Headquarters	Development area	Development area
Serious Fraud Office	Development area	Development area
Department of Energy and Climate Change	Development area	Development area

- **Strong** – good capability for future delivery in place, in line with the capability model. Clear focus on the action and improvement required to deliver transformation over the medium term.
- **Well placed** – well placed to address any gaps in capability for future delivery through practical actions that are planned or already underway. Is making improvements in capability and is expected to improve further in the medium term.
- **Development area** – the department should be capable of addressing some significant weaknesses in capability for future delivery by taking remedial action. More action is required to close those gaps and deliver improvement over the medium term.
- **Urgent development area** – significant weaknesses in capability for future delivery that require urgent action. Not well placed to address weaknesses and needs significant additional action and support to secure effective delivery. Not well placed to deliver improvement over the medium term.
- **Serious concerns** – serious concerns about current capability. Intervention is required to address current weaknesses and secure improvement in the medium term. (NB only used infrequently, for the most serious gaps.)

NOTES

1 Indicates department was not in existence in this year.

2 At the time of the two assessments the Department for Education was known as the Department for Education and Skills and the Department for Children, Schools and Families respectively.

3 The Ministry of Justice was established in May 2007 combining functions previously contained within the Home Office and Department for Constitutional Affairs. The data used here came from a rebaselining exercise carried out in April 2008.

Source: National Audit Office analysis of Cabinet Office data

Post publication this page was found to contain an error which has been corrected
[Please find Published Correction Slip]

1.5 In 2008, the Committee reported that 92 per cent of departments had implemented full commercial-style 'resource accounting', and all but three departments met the summer recess target for presenting accounts to Parliament. Since then there has been further progress, with many departments achieving earlier laying of accounts and all but one (The Ministry of Justice) meeting the summer recess target in 2009-10, despite the need to cope with the introduction of new international financial reporting standards in that year. Our financial audit work confirms that the general standard of financial reporting has improved. There is also evidence that departments are gathering information on the working capital aspects of their balance sheets in a more regular and automated way, though they are not generally reporting this information to management or using it to manage the organisation.

1.6 In 2008, the Committee noted consistent departmental underspending, suggesting that budgets and forecasts were not accurately linked to actual expected levels of activity and that voted funds were not being used effectively. Since then, underspends have slightly reduced, and remain just under three per cent of estimates agreed by Parliament. Overspends, which result in an automatic report by the National Audit Office to Parliament, remain at a very low level, though even these could have been anticipated through more sophisticated forecasting of expenditure.

1.7 Despite the improvements, the National Audit Office and the Committee continue to identify examples of poor value for money in central government in terms of programmes and projects not delivered according to the planned time, quality or cost. Beneath the high-level results, which suggest that Departments generally manage within their budgets, there is a wealth of evidence that their approaches do not constitute good financial management. Departments are struggling to prioritise scarce resources effectively in-year, so as to achieve value for money, and the centre of government has not to date set out an effective framework for holding them to account on this. There is no standardised central reporting of financial and operational effectiveness, though Treasury and Cabinet Office are now working on defining metrics and benchmarks to monitor departments' financial management performance more actively through departmental scorecards – these are expected to be in place by 1 April 2011.[3]

1.8 Spending cuts are still often reduced to 'top-slicing' of all programmes, or delaying delivery, rather than eliminating costs in a structured way. For example:

- The Ministry of Defence delayed the introduction into service of aircraft carriers by up to two years to release money in the short term. This saved £450 million over the first four years but subsequently added £1,124 million, a net increase of £674 million.[4]
- In 2009 we reported that, in the then Department for Children Schools and Families, budgets were not routinely prioritised during the planning process, so that the Department struggled to find savings to fund the Children's Plan.[5]

1.9 While departments have been tasked, under the Spending Review 2010, to make sustainable efficiency savings of up to 40 per cent, the evidence shows that they are unlikely to deliver these savings without improving their financial management capacity and capability. In July 2010, we reported that while there were some improvements to value for money resulting from departments' efforts to meet the targets set in the last Comprehensive Spending Review 2007, in a majority of cases examined, departments did not have the information on cost and performance to fully demonstrate that the savings had actually been made. In some cases the reported savings were clearly unsustainable.[6] We examine below the capabilities and behaviours underlying these results.

Lack of strategic influence of finance professionals within departments

1.10 The financial consequences of decisions need to be understood at all levels in the organisation. While the role of the Finance Director is crucial for leading management accounting and internal and external reporting, the Accounting Officer sets the overall tone for the organisation. His or her view of financial management will determine whether there is a culture of strong financial management or one where financial considerations are seen as issues for the finance team alone to manage.

1.11 The prevailing culture in the Whitehall civil service has historically been one where skills in strategy and policy are valued most highly, and our work suggests that Accounting Officers of major departments, who are generally not finance specialists, do not always see that financial management is an essential part of effective management. Consequently, Accounting Officers have not focused on rewarding good financial management or promoting its strategic role. In 2010, for example, we found that while there had been improvements in financial management in the Ministry of Defence, the Department's finance function did not have as central a role in strategic planning as it should, and financial management did not have a high enough priority to counter the tendency, in a constrained and complex external environment, to make over-commitments in its strategic planning.[7]

1.12 In general, staff can still be promoted to senior positions in departments without having demonstrated an ability to deliver cost-effective operations, which sends a message within the organisation that performing well on financial matters is not important for career progression. Despite this tendency, there is some good practice (**Improved practice example 1**). To develop this further, the cadre of finance professionals in departments need to be able to support the business with advanced analytical and business skills. Some finance departments, such as in the Home Office, are beginning to move in this direction by regarding their role as one of 'business partnering', rather than simply financial processing and financial analysis.

Improved practice example 1
Financial management in the Home Office

In 2004-05, the National Audit Office issued a disclaimer as we were unable to form an opinion on whether the accounts of the Home Office (the Department) were "true and fair", because of the lack of evidence. The Department was also consistently underspending against its annual capital budgets – in one year by as much as 25 per cent – giving rise to a cumulative underspend of £725 million. The Department received a 'serious concern' red rating in 2006-07 for financial management under the Cabinet Office's programme of Capability Reviews.

In January 2006, a new Accounting Officer took over and a qualified and experienced Director General of Finance was recruited externally. Strong, visible leadership from the top, focusing on matching resources to priorities and improving the financial capability of senior managers, has improved the Department's financial management culture:

- All staff with a budget responsibility are encouraged to include specific financial objectives in their performance agreements, and line managers to evaluate financial management as part of regular reviews.
- The Accounting Officer has made it clear that senior staff will be unable to gain the highest performance ratings unless they perform strongly on financial management as well as policy skills.
- The Department is using the Government Finance Profession graduate trainee accountant scheme to develop a cadre of in-house finance professionals and looking to them to act as 'business partners' to policy teams, as well as having a central reporting role.

In May 2009, we reported that the Department has substantially improved its financial management, including its overall financial governance, its financial planning, budgeting, monitoring, forecasting and reporting, and its arrangements to support financial decision-making.

The improved financial management culture has made a marked difference but the Department recognises the need for continuous improvement and has implemented a range of financial improvement programmes to address gaps it has identified. Since 2009, it has instituted a programme of finance compliance audits and refreshed its Financial Improvement Strategy, both of which are driving further improvement.

Source: Comptroller and Auditor General, Financial management in the Home Office, HC 299, 2008-09

Costs and financial risks are not always central to decision-making

1.13 Half of the finance directors we interviewed considered that they had seen significant improvements in the quality of financial analysis presented to support decisions on policy proposals in their department, and that proposals not adequately supported by financial analysis were now rejected. However, there is further to go in increasing the status of financial considerations in decision-making. For example, we found in the then Department for Children, Schools and Families that the quality of financial information in policy submissions to Ministers was not consistent. This affected the Department's ability to make informed decisions about the value for money of proposals.[7]

1.14 Operational and financial information for decision-making in departments often lacks sophistication, with modelling and scenario planning rarely used well. For example:

- The **Department for Work and Pensions** did not adequately pilot the use of private Pathways Providers, and had insufficient knowledge of the contractors' supply chains. Contractors' performance proved to be below JobcentrePlus performance and not commercially sustainable.[8]

- The **National Offender Management Service** failed at the start to appreciate the product customisation and business change required in implementing a new management information system. Combined with its inadequate oversight of the project and weak relationships with suppliers, this led to a doubling in programme costs, a three-year delay in programme roll-out, and reductions in scope and benefits.[9]

1.15 There will always be a degree of risk associated with delivering government projects and programmes. Departmental Boards need to understand the overall control system in place and monitor risk, including in arm's-length bodies, as part of their stewardship of the business, and must produce an annual Statement on Internal Control as part of the accounts. Our audit work on the quality of these Statements reveals a general disjointedness in risk management. Departments have tended to produce Statements on Internal Control specifically for external accounting purposes, rather than using them to help drive effective risk management.[10] For example in 2009:

- The Ministry of Justice failed to identify emerging control issues in the Legal Services Commission in time to prevent their accounts being qualified.[11]

- The Department for Business, Innovation and Skills underestimated the risks of the Customer First Programme that transferred the processing of grants and loans from local authorities to the Student Loans Company. The Department's subsequent monitoring of the Company in 2009, the first year of the Programme, did not pick up sufficiently early the significant failures in the service provided to students. As a result of the failures in the service provided by the Company in 2009, the Department needed to provide the Company with additional operating cost funding in 2010-11.[12] The Department has since revised its arrangements for managing arm's-length bodies.

1.16 In February 2010, the Treasury wrote to departmental finance directors to emphasise that "the statement on internal control is not an end in itself... The statement should reflect what is already happening and should be a natural product of the control framework... not based on a process designed solely for [the purpose]". In the summer of 2010 we reviewed the Statements on Internal Control published by government departments. The statements had improved and presented a more balanced review of the risks faced by departments and the actions they had taken to mitigate those risks.

1.17 Both non-executive directors and finance directors told us that, in their view, their Boards did not handle or effectively challenge the financial information presented to them as well as they might. One reason is the complexity of the Government accounting framework. For historical accounting reasons, there are differences between the expenditure framework which governs departmental budgets and that which governs Parliamentary Estimates and resource accounts. As a result, large blocks of public expenditure (over a third of the total) are outside the Estimate. This means it is very difficult to track spending from plans, through the money voted by Parliament, to actual spending and delivery of results. This restricts the ability of Parliament (and non-executives) to hold departments to account for their spending. Non-executive directors told us they were unable to make effective use of the resource accounts for scrutiny of, for example, delivery and risks, as they would in a commercial company.

1.18 In 2007, the Government proposed changes to address the accounting discrepancies. The proposals, known as *Clear Line of Sight – the Alignment Project*, were endorsed by Parliament in July 2010.[13] Once implemented from April 2011, the project will bring the expenditure frameworks almost completely into line. The proposals should also allow for improved financial management by:

- improving accountability and transparency of spending so that Parliament can hold departments better to account for how they have spent the money voted;
- allowing departments to retain income generated beyond the budgeted level; and
- requiring full consolidation of non-departmental public bodies within departmental accounts for the first time, to incentivise departments to take greater interest in the financial performance of these bodies and identify any risks.

The importance of "getting the numbers right[14]"

1.19 Good financial management is informed by good quality data. In our definition of 'enterprise' financial management, operational and financial management information is fully integrated and feeds directly into the production of accurate and timely external reports and accounts. Thus, preparation and scrutiny of the accounts helps with day-to-day management of finance, and vice versa. In 2008, the Committee recommended that departments should produce integrated financial and operational performance information, and present it within ten working days of the month end in a format that enables decision-makers to understand how much is being spent and with what effect.

1.20 Since then there has been limited progress. For example, in our report on Financial Management in the Ministry of Justice, we highlighted that operational reporting was not integrated with the Ministry's financial reporting.[11] Our March 2009 survey of 42 central government organisations found, in 18 cases, board performance reports held no financial information at all.[15] Finance directors we interviewed in 2010 pointed to difficulties caused by the need for manual manipulation of data to produce reliable reports, and the complications of machinery of government changes. While the content and quality of management information still has room for improvement, the speed of production of data for management at the month end has increased. Benchmarking data collected by the Treasury for the 17 main Whitehall departments in 2009-10 showed an average reporting cycle of around eight days from the month end.

1.21 In practice, however, the activity of producing annual resource accounts remains largely divorced from financial management within departments. Departments rarely prepare interim resource accounts, and essentially manage their finances based on cash, adjusted for working capital movements. Full resource-based information is created at the year end for Parliamentary reporting purposes. Resource information is therefore generally not integrated into, and does not drive, management of departments' business.

1.22 The Committee recommended that Boards should review their departmental balance sheet at least quarterly and seek assurance as to how cost-effectively significant fixed assets, such as land, buildings and equipment, are being utilised. However, in 2010, we found that use of balance sheet information remained generally very weak. Most departments did not report balance sheet information to Boards at all during the year, until production of the annual resource accounts. There was, consequently, no monitoring by senior management of stock levels, cash, debtors and fixed assets and no forward planning, for example, of asset write-downs or debtor management. We noted in 2009-10 that:

- the Ministry of Justice was holding increasing levels of cash which leads to a risk of poor value for money if not managed actively;[11]
- the Ministry of Defence could focus more on using its assets efficiently – there may be scope to realise savings in relation to asset holdings[7]; and
- the Foreign and Commonwealth Office's management information on estate characteristics was poor, affecting its ability to identify the need for change, make effective strategic decisions, and improve estate management to achieve better value for money.[16]

1.23 This lack of monitoring will be more important for some departments than others depending on the size of balances and risk involved, but the risk is that departments fail to spot impending problems that can have an impact on resources available for future service delivery, as well as leading to breaches of in-year budgets. For example, the Home Office did not monitor the balance sheet in 2008-09 and so failed to anticipate the accounting consequences of losing a court case. Once acknowledged in the accounts, the resultant liability led to the Home Office overspending against its overall annual budget and the accounts being qualified.[17] The Home Office began reviewing the quarterly balance sheet in 2010-11.

1.24 Government departments often have a legacy of multiple IT systems which do not adequately interface with each other.[18] There is rarely an automatic cascade of data from management accounting systems to resource accounts, and departments often use multiple data systems to piece together accounting information manually, which introduces risks to both the control of transactions and the accurate presentation of these transactions in the accounts. Moreover, there is no consistent approach to the configuration of Oracle-based accounting systems across government. For example, we found the Ministry of Justice's multiple financial systems and incomplete financial reports affected the Board's ability to monitor its overall budgetary position and its awareness of the Ministry's assets, liabilities and future cash requirements.[11]

1.25 However, in an example of improved practice, the Department for Education has moved its financial transaction processing to the shared services operation run by the Department for Work and Pensions. Such a move to greater consolidation of systems and processes has the potential to help rationalise financial management reporting tools and increase alignment across government, and could be adopted more widely. There is also improved practice at the Foreign and Commonwealth Office (**Improved practice example 2** overleaf).

Improved practice example 2
Financial management in the Foreign and Commonwealth Office

In 2005, the Foreign and Commonwealth Office (the Department) laid its accounts before Parliament in December, five months late. It had a history of consistent underspending against budget culminating in an underspend of £128 million in 2007-08, despite requesting extra funds during the year. Contributory factors were:

- lack of financial skills (In 2008, only 8 per cent of staff working in Finance were professionally qualified, against a central government average of 14 per cent);
- a lack of trust in the accounting system to provide accurate monthly actual figures;
- budget holders focusing on avoiding overspends to the detriment of delivering value for money;
- a lack of ownership of budgets; and
- a lack of personal accountability for significant underspending.

In 2007-08, the Department took action to avoid future underspends, introducing a new internal challenge mechanism, with detailed scrutiny of each Director General's quarterly forecasts. The Department also did work to strengthen the link between its business planning and resource allocation, and introduced for the first time a system of staff activity recording as a basis for providing a clearer picture of the real cost of pursuing each of its objectives. It now has better information on the costs of individual embassies. However, there is further to go to implement a workable and effective system of costing activity in all locations to enable it to make informed decisions about its operational priorities.

The Accounting Officer and the Board provided a strong lead to the mission to improve the standards of financial management, from a low base, throughout the Department. They recruited a qualified Director General of Finance, who sat on the Board, to signal the corporate importance of finance.

The Department launched the 'Five Star Finance' programme in 2007, with the vision:

- to be the best in Whitehall;
- to use simplified, standardised and streamlined processes and tools to ensure the Department gets things right first time, and makes best use of resources;
- to become a beacon organisation – learning from and sharing best practice with others; and
- for the whole finance community to strive for excellence, delivering an efficient and effective service to customers, and developing their own skills.

It also has a professional finance training programme to build its numbers of professionally qualified staff. It introduced training programmes to improve skills for non-finance staff, though it needs to do more to improve take-up of these. Finance staff embedded in directorates have a main reporting responsibility to the policy area, and a secondary one to the finance directorate. Weekly finance profession meetings within the Department under a head of profession help create a corporate approach to finance.

Source: Comptroller and Auditor General, Financial Management in the Foreign and Commonwealth Office, HC 289, Session 2008-09

1.26 Even where departments have data suggesting management action is needed, the evidence from our work suggests they do not always let it shape their strategic planning and priorities. For example, we reported in February 2010 that the value for money case for improving major trauma care in England was made 20 years ago, yet little action has been taken by the Department of Health and NHS to make improvements since that time, and there remains a lack of accurate and complete information to inform the planning of services and assess the effectiveness of care provided.[19]

1.27 The next step is to use information to shape the business strategy, enterprise-wide. For example, HM Revenue and Customs has various programmes to encourage customers to move towards less expensive forms ('channels') of communication, while still meeting their service needs. These programmes have the potential to achieve significant value for money benefits for the Department with, for example, the planned expansion of online filing of tax returns expected to achieve gross savings of £278 million over seven years to 2013-14. However, we found the Department had no integrated plan for this communication 'channel strategy' and no department-wide targets and milestones. It was, therefore, not well-placed to assess progress, the need for corrective action, or demonstrate whether it is achieving optimal value for money.[20]

Need for greater understanding of cost and value drivers

1.28 In 2008, the Committee of Public Accounts considered that departments needed much more reliable information on the unit costs of outputs to gauge whether costs are reasonable and commensurate with the quality of service delivered. In 2010, the sophistication of costing still varies and, in recent value for money examinations across government, departments have consistently been unable to provide us with accurate programme costing data for their activities.[21] Because of this lack of data, departments have also been unable to measure, and set targets to improve, productivity.

1.29 The premise of the 2010 Spending Review[22] is that departments will be expected to prioritise their main programmes based on evidence of costs and benefits. All finance directors and non-executives we interviewed had concerns over the inherent difficulty of linking their costs through to the value of outputs and outcomes being achieved, so that decisions could be made on the basis of value for money. They were also concerned that departments lacked the skills to make the linkages more effectively. Our evidence backs this up (**Figure 4** overleaf).

1.30 Costing complex government activities can be technically difficult, and measuring value delivered is even harder. All departments are attempting to make improvements in this area, but there remains a need for much more sophistication and rigour. Departments will be required, from 2010-11, to provide impact and input indicators to support their published business plans. We will be publishing guidance on good practice in costing for departments in spring 2011.

Figure 4

Government departments need a greater understanding of costs and value drivers

The Major Projects Report found that the Ministry of Defence's ability to achieve savings by reducing the number of items to be procured is limited. This can be due to significant development costs and non-recurring costs being spread over the unit cost of items. Reducing the number of Nimrod MRA4 reconnaissance aircraft from 21 to 9 has had the effect of increasing the unit cost figure by three times the amount expected when the original investment decision was taken.[1]

A strategic review by the Department for Communities and Local Government found it was cost-effective to retain Firebuy as an arm's-length body for the procurement of equipment for fire services. The review was based on incomplete savings and cost evidence. By July 2010, Firebuy had cost the Department almost £17 million, nearly double the savings and income it generated. We found the agreed approach to framework contracts between the Department and Firebuy acted against maximising savings in the £120 million spent annually on fire and rescue service procurement.[2]

The Ministry of Justice did not understand the costs of its activities within prisons, the probation service, and the courts in sufficient detail, reducing the Ministry's ability to allocate resources on the basis of relative financial and operational performance of individual prisons, probation services and courts.[3]

In rolling-out a programme of screening of young people for chlamydia, the Department of Health did not monitor local spending or evaluate the most cost-effective local programmes to help increase efficiency.[4]

The Department for Work and Pensions did not monitor the cost-effectiveness of different interventions within the debt recovery process (such as letters, civil litigation, and debt collection agencies) and the success rates of each (including amount and speed of recovery) to help it decide how to target recovery effort.[5]

There was no framework in place for evaluating the achievements of the Government's 2008 strategy for tackling problem drug use and hence targeting future resources.[6]

In 2009, we found The Highways Agency only just beginning to establish unit costs to enable them to challenge contractors' costings and establish benchmarks for improvement.[7]

The Legal Services Commission had not marshalled the knowledge of its local managers well enough to develop a good understanding of the market for criminal legal aid, such as the cost structures of different types of firms and their profit margins.[8]

The Department for Business, Innovation and Skills was not able to clearly identify how much it spent running six support schemes for businesses during the recession, owing to a lack of clarity and consistency in how it recorded and allocated staff and consultancy costs at that time.[9]

The six largest employers in central government could not identify the total cost of recruitment or the cost of a typical recruit, which are standard measures of efficiency used by the private sector.[10]

Sources:

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Part Two

Transforming financial management

2.1 The Government has already set out a commitment to improve financial discipline and has stated that it is integral to getting the deficit under control. Moving central government to what we have defined as 'enterprise' financial management means:

- a civil service culture where decisions are made on the basis of good information, and with an understanding of the financial consequences in both the short term and the medium to longer term. Policy makers will take financial considerations effectively into account either through their own knowledge or by accessing relevant expertise. This contrasts with the current culture which is broadly driven by the development of policy with financial considerations bolted on afterwards;
- cost reduction programmes built into routine business, and based on a sophisticated understanding of costs and value delivered, rather than the top-slicing of budgets undertaken in response to budgetary constraints;
- the way that staff are assessed and rewarded helps incentivise them to seek sustainable cost reductions and pursue value for money; and
- all senior civil servants demonstrating a degree of expertise with financial information and concepts, so that they can make responsible corporate decisions.

2.2 We consider that transformational change is needed to achieve this, and that that requires an explicit change management programme across the civil service. The Treasury has acknowledged this, with the publication of *Managing taxpayers' money wisely: commitment to action*, in January 2011. Using a well-known model of good practice in leading change[23], we looked at what steps are needed to enable change, what is currently planned, and who needs to take action (**Figure 5** overleaf).

The urgency for change

2.3 The need to achieve substantial cost reductions, while also pursuing new policy objectives, has helped provide a shared **sense of urgency** for improved financial management within government departments. However, ensuring that financial management is not focused on a narrow departmental perspective which may be contrary to overall value for money is crucial to the success of the cost reduction programme.

Figure 5

Progress on the steps needed to enable transformation in government financial management

● (green) Sense of urgency (paragraph 2.3)	● (amber) Powerful alliance for change (paragraph 2.4-2.6)	● (amber) Vision of the future (paragraph 2.7)	● (red) Communication (paragraph 2.7)
● (amber) Empower/remove obstacles (paragraph 2.8-2.10)	● (red) Plan for and create short-term wins (paragraph 2.11)	● (red) Sustain momentum (true change can take 5-10 years) (paragraph 2.11)	● (red) Institutionalise change (so the next generation believes in it) (paragraph 2.12-2.15)

NOTES

1 The eight headings in this table are based on those in *Leading Change* by John Kotter. Harvard Business School Press, 1996.

2 Key: green – already in place; red – not yet in place; amber – partially in place.

Source: National Audit Office

Leading the change

2.4 The **powerful alliance** for change in financial management is growing. Ministers have made clear they wish to see strong financial management practice and evidence-based decisions on cost reduction. The Treasury has produced a clear statement[24] about the improvements they wish to see. The *Protocol for Enhanced Departmental Boards*[25] requires finance directors to be given greater influence in departments and also requires non-executives individually and collectively to hold departments to account. What is still missing, for the most part, is for the most influential non-finance professional leaders in Whitehall, the Accounting Officers, to associate themselves personally and publicly with improvement plans to achieve 'enterprise' financial management.

2.5 Professional financial leadership across the civil service could also be stronger. The Head of the Government Finance Profession (HOGFP) is currently a part-time role, supported by a small unit within the Treasury. The actions of successive HOGFPs have led to substantial improvements, such as by improving the quality of finance directors in departments, but they alone have not had the influence to tackle the barriers to embedding financial management in departments.

2.6 The Finance Leadership Group, of Directors General with responsibility for Finance of ten of the highest spending government departments, represents the interests of the Government Finance Profession and works with Treasury in driving improvements to financial management. The Group has promoted the Finance Director Development Scheme to increase professionalism, and a range of good practice tools. However, its collective expertise in financial management has not been coupled with adequate resources or influence, across and at the top of government to drive fundamental improvement in financial management. It does not have a clear remit, from the Treasury and/or Cabinet Office to work collectively on finance matters, such as achieving coordinated cross-government savings.

Communicating a clear vision of what is required

2.7 The Treasury, with stakeholders including the Finance Leadership Group, has set out a **vision** of future financial management in *Managing taxpayers' money wisely: commitment to action*. Accounting Officers and Finance Directors have yet to **communicate** the vision simply to the senior civil service and below, setting out the link to achievement of departmental objectives and the staff behaviours they wish to see. Nor is the role of the Finance Leadership Group in communicating and delivering this vision clear. In addition, the vision and expected behaviours will need to be reinforced by the messages that the Treasury's Spending Teams give to individual government departments as they work with them on managing spending throughout the financial year. An overarching strategy to deliver the vision, with clear allocation of responsibilities, will be essential.

Improving transparency and flexibility in central government finances

2.8 Practical **obstacles** to improving financial management remain, although the Treasury is taking action. In particular, whilst control of current year spending is important, the way the Treasury controls departments' spending in year can unintentionally lead to poor value for money decisions. Though overall budgets are set over four years in Spending Reviews, and accounting is on an accruals basis, the drive to meet annual expenditure limits (known as 'control totals') set by the Treasury has the greatest influence on departments' behaviour. Rather than working to a rolling four-year financial plan, departments' foremost concern is to stay within, and as close as possible to, these annual expenditure limits, especially towards the end of the financial year. The strongest incentive in the system, for an Accounting Officer, is the threat of having to account for any overspend against annual expenditure limits.

2.9 The budgeting system used by the Treasury to plan, allocate and control public expenditure has been designed to: support the achievement of macro-economic stability by ensuring that public expenditure is controlled in support of the Government's fiscal framework; and provide good incentives for departments to manage spending well so as to provide high quality public services that offer value for money for the taxpayer.[26] In practice, we found that the system as operated works towards the first objective, but can create perverse incentives as regards the second. The absence of flexibility between the different expenditure limits is also a barrier to intelligent strategic financial management. In particular:

- End Year Flexibility was introduced to allow departments to set aside funding for use in future years of the spending review period, and avoid the incentive to 'spend up to the budget' at the end of the financial year. However, in practice, fiscal tightening has meant that the Treasury has restricted departments' access to the accumulated funds, and the tool has largely lost its effectiveness.

- There are fewer incentives for 'spend now, save later' type efficiency improvements.
- Parts of a department's expenditure that are highly dependent on economic circumstances, such as benefit payments, are separated from running costs, and subject to a separate control (known as Annually Managed Expenditure). Departments cannot benefit from any savings achieved in annually managed expenditure. Therefore they have no direct financial incentive to invest in projects that might help to reduce it.

The Treasury is currently reviewing the Spending Control Framework with particular emphasis on the incentives around End Year Flexibility and Annually Managed Expenditure.

2.10 These short-term incentives have been reinforced by the way centrally-led savings and efficiency programmes have been implemented. The Treasury set only annual value for money savings targets for departments under the Comprehensive Spending Review 2007. As we reported in July 2010, this short-term approach was cascaded down within departments, and meant that some valuable savings initiatives, that would have taken longer to bring results, were not achieved.[27] The Treasury revised its approach to efficiency savings in the Spending Review 2010, in response to criticisms from the Committee, including dropping the use of top-down annual savings targets.

Sustaining momentum through good practice and benchmarking

2.11 **Short-term wins** within departments will be important to help improve buy-in of staff and **sustain momentum**. The improved practice in departments such as the Home Office could be drawn upon to illustrate specific day-to-day benefits that staff across Whitehall can relate to and replicate, and peer pressure could provide further impetus. In our March 2009 survey, we found that 67 per cent of departments and non-departmental public bodies did not benchmark their financial performance at all, while 26 per cent did some benchmarking.[28] The introduction of the new departmental 'scorecards'[3] offers the opportunity to incorporate key financial indicators that could be benchmarked across government and help drive up financial management standards.

Embedding improvements in civil service culture

2.12 **Institutionalising the change** means making sure it is embedded within or reinforced by the culture of the civil service in terms of formal standards, performance appraisal arrangements, and training, which has hitherto not been the case.

2.13 The Civil Service Code of Conduct was revised in 2010 to require civil servants to "carry out your fiduciary obligations responsibly (that is make sure public money and other resources are used properly and efficiently)". However, guidance published in March 2010 for managing performance in the senior civil service does not mention the importance of financial management.[29] The Cabinet Office is developing a new civil service appraisal system – it will be important to ensure that it adequately incentivises good financial management.[30]

2.14 The changes to the influential peer-led Capability Reviews of departments for 2010 onwards incorporate a new value for money assessment[31] but we have reported that this does not go far enough in addressing the host of financial challenges departments face, highlighting the need to make use of metrics to assess the department's capacity to deliver.[32]

2.15 In the civil service, financial management is defined as a mandatory core skill for all senior and middle manager grades. Training is provided centrally with a three-level training programme for non-financial staff. The first level of training is delivered by e-learning and take up is monitored centrally, but at the higher levels there is no consistent approach to rolling-out training across departments. Some departments, for example the Home Office, have begun to report to the Board on take up of financial management training in different directorates as a way of driving progress. Centrally, the Cabinet Office is currently reviewing the whole Professional Skills for Government Framework.

Appendix One

Methodology

Fieldwork was carried out between April 2010 and June 2010. The main methodologies used were:

Methodology	Reason for carrying it out
Review of published assessments of financial management	To build a picture of the overall state of financial management in government through synthesising the work of others. The main sources of evidence were: • Capability Reviews of government departments led by the Cabinet Office since 2006; • an ICAEW survey of public sector accountants *Public Sector Finances: Views from the inside* (June 2010); • reports by PriceWaterhouseCoopers into public sector financial management: *A place at the top table? Raising finance's game in the public sector* (2010); *Finance at the crossroads, The changing role of finance in government and the public sector*; and • the financial management maturity model produced by the Chartered Institute of Public Finance and Accountancy.
Review of findings from published National Audit Office work in the previous two years	To determine how widespread weaknesses in financial management were across departments.
Analysis of high-level indicators of financial management performance in Whitehall	To provide high-level quantitative evidence indicative of the effectiveness of financial management across Whitehall since 2004-05. Measures we looked at included: • the timeliness of departments' annual accounts; • the number of departmental accounts qualified by the auditors; • the level of over and underspends by government departments against their budgets; and • use made of Supplementary Estimates in which departments ask Parliament for additional funding during the financial year.

Methodology	**Reason for carrying it out**
Review of detailed evidence on financial management maturity for a purposive sample of five departments	To help us understand in more detail the level of maturity of financial management in government as measured against our *Financial Management Maturity Model*, which can be found at http://www.nao.org.uk/help_for_public_services/financial_management/fmmm.aspx This was not a formal assessment of each department and we did not set out to obtain a full set of evidence against the Model, but rather to gain a deeper understanding of the general issues that we identified through other methods.
A group discussion with members of the Finance Leadership Group	This provided a consensus view on the systemic barriers to better financial management that the group felt were most important.
Semi-structured interviews with: • finance directors of eight government departments; • finance directors from five non-departmental public bodies; and • non-executives and other board members from six departments.	Using the NAO *Financial Management Maturity Model* as a guide for questioning, we asked interviewees to consider the current state of financial management, any good practice, and what could be done to overcome the barriers. We recorded the interviews, transcribed them and carried out analysis of the results using ATLAS software, to ensure a robust set of qualitative data from which to identify the barriers to improvement and any solutions.
We commissioned PricewaterhouseCoopers to provide a ‘thought piece’ on how to incentivise senior management in government departments to deliver the Financial Management agenda	This helped us identify key issues on how to incentivise staff and provided us with an insight into the views of finance directors in the wider public sector, outside central departments, on the key issues to be addressed in improving financial management.

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CORRECTION

Figure 3 (p12) of the report incorrectly shows the Ministry of Justice as having a red rating (Serious concerns) for its ability to plan, resource and prioritise in 2008-09. The rating should be amber/red (Urgent development area).

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