National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 487
SESSION 2010–2011

3 MARCH 2011

HM Treasury

Progress in improving financial management in government

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.