Good budgetary processes: comparators

Case studies from the public and private sector

PwC research report commissioned by the National Audit Office

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1. Introduction

Overview

The last four years have seen a significant downswing in global economic conditions and, as a result, financial matters have moved to the top of the agenda. Budgeting and forecasting are the key pillars of good financial management and the need for effective budgeting has never been greater in an environment of reducing funds and a focus on rapid cost reduction without compromising service delivery. These conditions pose many challenges for both the public and the private sectors and there is a clear need for organisations to consider the suitability of budgetary processes for the current economic environment.

This research examined a number of private sector companies, mainly based and/ or operating in the UK and several public sector organisations, including both English Local Authorities and Treasury/ Finance Departments in other countries around the world. The purpose was to identify the budgeting and forecasting approaches they are currently using and developing in order to meet their organisational needs, particularly in the current economic environment.

This report is NOT a Good Practice Guide, but rather provides insight and context on different budgeting approaches developed in both the public and private sectors here in the UK and internationally. It is hoped that this insight will assist senior finance staff in Central Government meet the significant budgetary challenges they will face in the coming years.

Different sectors, same challenges

Unsurprisingly the research found that that many of the challenges faced are common across all sectors and jurisdictions. Local Authorities are undergoing significant organisational change at the same time as facing a changing and more demanding social environment, whilst operating in a significantly constrained funding environment. Interestingly, in some cases, the constrained funding environment is necessitating organisational change, but meeting the costs of implementing this change, even where downstream savings will accrue, remains a key challenge.

Similar challenges are being experienced in central governments. The three Treasury/ Finance Departments consulted all indicated that, to varying degrees, they are facing increases in demand-led support (such as increased benefits payments) and reduced tax incomes. These Departments were actively examining how services could be delivered more effectively through change in organisation, processes and policy.

In addition, as the economic downturn impacts on customers, many private companies are also facing severe financial pressures and a changing business environment. All the private companies that participated in the research noted that they have to deal with high volatility in some of their key business drivers and this has influenced the development of their financial management approaches. A key theme from all companies in the research was that fluctuations in the business environment were becoming the ‘norm’ and that **agility and flexibility** in the budgeting process was vital to address these challenges. Traditional fixed period budgeting on its own is no longer seen as a sufficient tool to deal with this environment effectively. Budgeting processes that effectively **integrate** operational planning, financial budgeting and the overall performance management regime of the organisation are high on the aspiration list of research participants across all sectors.

This is no ‘silver bullet’

An important finding was that there is no ‘silver bullet’ to deliver the perfect budget process. We observed a mix of approaches ranging from the traditional, through to the forward thinking, innovative (and sometimes controversial) approaches, which have been tailored for specific organisational circumstances. Furthermore, no single organisation considered that it had all the answers. Instead organisations view the budgetary process as a complex mix of environment, rules, practice, values, people and behaviours that is evolving and requires constant effort and work to drive forward and improve.

Range of approaches, similar themes

There is a wide range of approaches to budgeting identified across the case study group. However, a number of key themes are consistent across all sectors, which are discussed in this report, and include:

- All organisations prioritise "must do" expenditure; whether that be regulatory or statutory; and only when those commitments are met, is other expenditure then prioritised. A range of approaches are used to prioritise non-mandatory expenditure but in all cases strategic intent (whether they are set by a Corporate Board or the Political Leadership) is a dominant factor;
- Closer integration between the Finance function and the other functions is also key. In all case studies, the Finance function owned the budget process but there are different governance models for monitoring, allocating and then re-allocating funds. It was observed that better integration between all budgeting parties is a key aspiration of all participants in all sectors.

In addition, and perhaps most importantly, the identified common aspiration of all organisations was to create a environment/ culture which:

- clearly defines its goals and articulates a common view of success;
- encourages good behaviour through the buy-in of the key stakeholders within the organisation; and is fully integrated with the performance management regime at all levels including individuals' scorecards. As a result, whilst there are a number of processes and approaches which can be implemented, achieving budgeting success is also dependent on nebulous 'human factors' which are more challenging to implement.

Terms of reference

In February 2012, the National Audit Office (NAO) commissioned PwC to prepare case studies on *Good Budgetary Processes: Comparators*. The case studies have been selected from both the public sector organisations (international central government and UK Local Authorities) and large private sector companies. The research seeks to learn from good practice outside UK Central Government and focuses on:

- The budget processes in place.
- Approaches to prioritising expenditure where there are competing demands for funding.
- Using the budgetary process to implement spending reductions.
- The extent to which performance information is applied in the budgeting process.

This report summarises the findings taken from the individual case studies to provide practical information and advice which can be applied across Central Government to improve budgetary practices. This report does *not* provide a detailed analysis of end-to-end budgeting processes but explores key themes arising from the case study research consistent with the focus areas above.

Report structure

This report is structured as follows:

- Methodology;
- Budgetary process;
- Prioritising expenditure;
- Finding efficiencies;
- Using performance information; and
- Relevance to Central Government.

In addition, the report contains the following appendices:

- Appendix A: Topic guide;
- Appendix B: Case studies; and
- Appendix C: Bibliography.

2. Methodology

Introduction

The purpose of the research was to focus on identifying good practice and lessons learned from across the case study candidates, with a view to providing some insights on the budgeting approaches applied and developed.

The case study candidates were selected from organisations with different budgetary practices, aims, structures and cultures. The intention therefore is to learn from a range of approaches and identify good practice which can enhance current budgetary practices. The methodology adopted is outlined below.

Case study selection

We developed case studies from across three sectors and identified organisations in each on the following bases.

Sector	Rationale for sector
International Government	To develop an understanding of approaches taken at the macro-level (i.e. HM Treasury/ Dept of Finance equivalent organisations).
UK Local Authorities	The sector has had to implement very significant spending reductions in recent years.
UK Companies	To learn from areas outside of Government and identify new approaches which have not yet been applied in the public sector.

The case studies were developed following a series of interviews with the participant organisations, and were undertaken between 6 March and 3 April 2012. The completed case studies were agreed with participants prior to making the information available to ensure the information had been accurately reflected. Private sector case study candidates have been anonymised.

Topic guide development

A detailed topic guide was developed and tailored for the individual sectors and focused on the following areas of study. The Topic Guide covered:

- **The budget processes in place** – including governance structure, engagement of external stakeholders, budgeting approaches used (incremental, zero based etc.), communication of the budget.
- **Budgeting and spend prioritisation** – approaches to ranking and prioritising expenditure options; the analysis techniques used; any differences across expenditure types; the information used to support decision making; using budgeting to reduce expenditure; managing interdependencies; and encouraging good corporate behaviour.
- **Linking strategic planning and performance to the budgeting process** – understanding how strategic objectives and performance are used in the budgeting process.

The main topic guide has been included in **Appendix A** of this guide.

Wider consultation/ research

To augment the case study findings, a series of consultations were undertaken with a number of PwC partners and directors with extensive financial and budgeting experience. This provided additional insight and context to the findings from the case studies undertaken.

3. The budgetary process

Introduction

In assessing the overarching budgetary process, we considered the:

- Budget framework;
- Budgetary methodologies; and
- Allocation of resources to budgetary activities.

These elements are discussed in turn.

Budget framework

We found that the typical budget framework adopted by in the case study group included the following elements:

- **Timeframe –** generally a focus on a 12 month timeframe that aligns to the next financial year, although increasingly this is being set as part of broader rolling plans, agile financial allocations and within the context of a longer term financial planning horizon;
- **Oversight/ Governance –** oversight by a Board/ Cabinet who typically set and oversee the financial constraints and then approve the final budget;
- **Challenge** – use of challenge functions made up of senior management (and politicians where relevant) to consider robustness of all budget proposals and reapportionments; and
- **Budget rules –** all organisations had a set of clear and documented rules around budget controls including such items as end of year flexibility, in-year flexibility and change control.

There were a number of interesting observations from the research and a number of trends stood out. These tended to reflect the current financial constraints and the pressure for organisations to be more agile in managing finance. Many organisations are being forced to think beyond the restrictions of a traditional budgeting framework and to develop it to better match the nature of their operating environment.

Medium- and Longer-term Contextual Setting

Some examples of how this is evolving in practice are set out below.

Internationally

The Australian Central Government sets a detailed 1 year budget in the context of a rolling 4 year Medium Term Expenditure Estimate which is updated twice a year. This medium term budgeting is typical in many countries but where Australia goes one step further is in the production of an additional **40 year Intergenerational Report** to consider longer term issues such as demographic pressures to inform 'shorter term' budget decisions.

Private Sector

A longer term approach is also being adopted in many areas of the private sector, particularly those with long-term assets and associated long-term revenue contracts. For example, one case study company develops products which have a 20-25 year life span and the sales contracts often incorporate a maintenance element for the life of the product. Therefore the organisation has reasonable certainty over costs and income over a long time period. The company uses a rolling 10 year plan which incorporates the projected asset related finances and this in turn contributes to the formulation of targets and provides a context for preparation of a more accurate short-term budget. This budget is flexed numerous times during the year to take account of unanticipated events.

Oversight/ Governance

Beyond Budgeting

A private sector example of a company that works in a volatile sector where uncertainty is common, has sought to find a more appropriate method which they believe addresses common 'symptoms of traditional budgeting'. These symptoms mostly relate to agility, alignment and behaviours. The company experiences extreme resource price volatility and unanticipated physical events in its production and exploration activities and their response has been to implement the '**Beyond Budgeting'** methodology (explained in greater detail further below).

Increased Integration

Integration through aligning all parts of the organisation is a key objective. Budgeting is a fundamental part of the overall business planning process and aligns the strategic and operational planning across all parts of the organisation. In one case study example, sales volumes was the key driver for planning throughout the entire organisation's supply chain including: procurement, production, personnel and finance-raising.

Challenge functions

The need for a top-down challenge function was justified for a number of reasons; firstly on the basis that only the strategic leaders have the visibility across all parts of the organisation to identify priorities. Secondly, "*Turkeys don't vote for Christmas*" was one comment made during the research and therefore a central, senior challenge function must be performed to identify potential padding.

Case Study finding – using 'challenge chambers'

- It is important to get the balance right between the need to avoid micro-management by senior staff in the first instance and the need to ensure there is equal scrutiny across all areas of expenditure in the second.
- A number of the case studies identified the use of 'challenge chambers' (or similar mechanisms) as an effective way to address this issue.
- This would involve a senior management team (and elected officials in a local authority setting) assessing and robustly challenging the budget proposals put forward by the individual divisions/service lines of the organisation.

Conclusions

The examples illustrate that there is a developing trend to tailor the budgeting framework to match the operating environment conditions rather than adopt a one-size fits all approach. For most organisations this has led to:

- a significant emphasis on longer-term planning to inform and reflect the multi-year impact of many decisions;
- more frequent updates, through rolling budgets or other means, reflecting the need to react more quickly to changes in a more volatile environment; and
- adoption of flexible budget rules that recognise the importance of the longer-term budget and align with good budgeting business sense.

In organisations with a very volatile environment, tailoring the framework to match real conditions has required a move to budgeting at event level.

Lastly, there was a trend in highly performing organisations that experienced and skilled managers with financial management expertise were trusted by the senior management. As a result only broad targets were deemed necessary and freedom was given to managers to "spend to achieve" without reference to tight spending controls.

Budgetary methodologies

The typical methodology for creating the budget adopted by most organisations comprised a combination of both top-down and bottom-up budgeting, with the top-down setting the high level financial outcomes and constraints and the bottom-up developing the detailed plans and budgets to fit the constraints set.

Incremental budgeting is the predominant feature of many of the approaches used. However this traditional approach has recently been supplemented in many organisations with targeted one-off investigations, or 'deep dives' of specific spend areas to identify if value for money is being delivered and if there are opportunities for spend reduction. There was also evidence of a trend towards a targeted zero based budgeting (ZBB) approach in areas of spend with high materiality and volatility. This emerging trend reflects the recent change in economic conditions and the impact this has had on the funding environment.

The research also identified a number of other approaches being applied in the private sector and these are discussed below.

Demand-led analysis

One case study company has made a major move towards a demand-focused budgeting approach, which includes the following components:

- forecasting customer activity (levels of usage);
- parts reliability and replacement forecasts; and
- maintenance forecasts.

This approach requires a very detailed understanding of its production in terms of reliability and maintenance requirements. Importantly the business is continually improving mechanisms to support this. The company indicated that modelling the budget around the assets, forecast customer demands and maintenance schedules over the long term, has made the short term budget more accurate and the business more able to forecast changes that may occur.

Beyond Budgeting

One case study company has adopted the 'Beyond Budgeting' approach as a way to address the challenges of its volatile business environment. Their view is that traditional budgeting is no longer relevant in the modern age. The approach has the following characteristics:

- They have moved from an annual process to a continuous process;
- KPIs are relative rather than absolute and performance evaluation is holistic;
- Targets are set over varying time horizons as appropriate for individual teams. There is a view that realistic stretch targets are more effectively set, monitored and delivered by committed people 'on the ground' rather than centrally;
- Resource allocations are event driven, not calendar driven, so decisions are taken at a time when most information is available, not at an arbitrary time of year or based on levels allocated in previous years;
- Increased trust placed with managers but with heavy sanctions if the trust is broken.

The company claims to have more accurate financial information on which to base planning decisions, there is reduced 'gaming' in the process and employees are empowered to make decisions.

Conclusions

Incremental budgeting remains popular because it requires a relatively lower level of resources. It is also more appropriate where expenditure (and revenues where relevant) are stable and predictable. However, an incremental approach to budgeting can be a self-fulfilling prophecy and creates a bias towards supporting the status quo. Therefore, in a dynamic environment, adopting a more driver based or zero based budgeting method could encourage better value for money decisions and has delivered efficiency and cost reduction.

Freedom in the private sector reflects the greater flexibility they have to operate, for example in areas such as 'spend to create' and 'spend to save'. Robust 'bottom line' targets, but with flexibility in terms of how these are achieved, can give managers the freedom to spend more money if it creates more value (i.e. increases profitability). This is much more difficult in the public sector, because in most instances there is no direct link between expenditure and revenue generation. However, where this does exist, the budget process could be made more flexible to encourage innovation and entrepreneurial approach.

Across all sectors, the approach to budgeting is not standing still. Financial pressures provide incentives for organisations to change and while incremental budgeting is not ignored there is a significant move towards matching the budgeting approach to the environment. Organisations consider that this is making them more effective, better able to respond to change and, in the case of the private sector, more profitable.

Allocation of Resources to budgeting activities

Other PwC research[1] found that in almost half of all cases, the percentage efficiency target placed on the Finance function was greater than the percentage efficiency target placed on the organisation as a whole. This is highly suggestive of a trend towards lower levels of resources being allocated to finance (and budgeting) at a time when financial experience should be at a premium to organisations.

This comes against the backdrop of a longer term trend towards greater integration between the Finance function and the other directorates. This is reflected in the increased popularity in recent years of 'Business Partnering' in both the public and private sectors.

Case study finding – Business Partnering

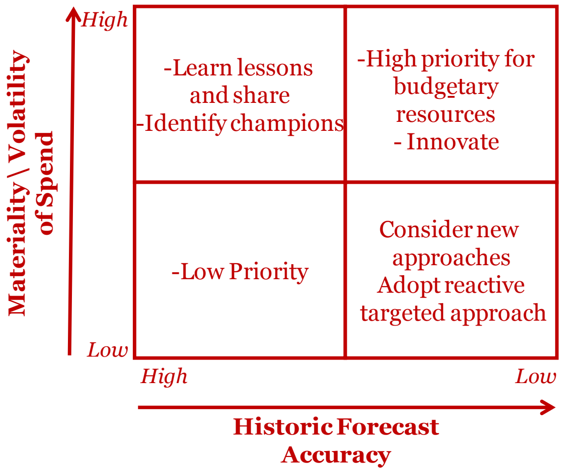
- Business Partnering is a dedicated management accounting function where staff interface with the rest of the organisation. Depending on the size of the organisation a number of 'business partners' (typically management accountants) will take responsibility for monitoring and working with a specific area/division on their budgeting and financial reporting throughout the year. The role of the business partner includes:
  - Developing the divisional budget with the relevant Director and senior management;
  - Monitoring expenditure within the division throughout the year against budget;
  - Working with the relevant director and divisional staff to proactively address issues as they arise;
  - Developing a detailed understanding of the specific area of the organisation and understanding the key cost drivers to be able to inform the next budget setting round.
- The business partnering role is the bridge that links finance and rest of the business as it seeks to increase the understanding of the business within the Finance function and also to increase financial awareness and competence across the business.

[1] PricewaterhouseCoopers: Stepping Up – The challenges for Finance in the public sector 2011

Focusing more specifically on approaches to allocating resources within budgeting more efficiently and effectively, one of the case study companies has developed a 'Budget Effort Prioritisation Matrix' to improve budget accuracy. This is explained further below.

Budget Effort Prioritisation Matrix

Step 1: Map all expenditure areas onto the quadrant below.



Step 2: Depending on where each area of expenditure is located determine the appropriate course of action:

- **Low materiality/ volatility, high historic forecast accuracy** – typically a relatively low level of resources should be allocated here and is a low priority for management.
- **Low materiality/ volatility, low historic forecast accuracy** – the techniques/approaches being applied are should be changed because a low volatility area should be more easily forecast.
- **High materiality/ volatility, high historic forecast accuracy** – the approaches being applied in this area are working and there should be scope to apply the learning in these areas to other expenditure areas.
- **High materiality/ volatility, low historic forecast accuracy** – this area is where management should be focusing most of their attention.

Value of good budget information

More efficient and effective allocation of resources to budgeting activities should, in the first instance, improve budget accuracy. However, this raises an issue in terms of the value organisations place on having good budgeting information. If an organisation can derive very significant value or benefits (profits) from budget accuracy, they are more likely to devote greater resources to achieving improved accuracy.

Not specific to the case study group but given the point above regarding the higher levels of efficiencies being sought from the Finance function, relative to other parts of the organisation, it suggests that good budgeting information is undervalued. Or perhaps more accurately, **too often organisations do not understand or have not identified the financial cost of poor budgeting/ financial forecasts**. Therefore there is potentially a major gap in many organisations' understanding of the value of good budgeting. It is not clear to many in senior management that good budgeting accuracy can identify and deliver efficiencies, improve resource allocation and allow for a better informed strategic planning process.

Data analysis over data capture

Other PwC research[2] has highlighted that top performing firms are increasingly spending more time analysing data, rather than simply capturing the data. In general, finance functions have become increasingly efficient at the transactional level (e.g. through the use of technology and shared service centres) and therefore, other things being equal, data capture now requires a lower level of resources than was previously the case.

As a consequence, higher performing organisations have used the resources released from transactional activity to undertake analysis and are using this additional insight to inform strategic planning and budgeting in their organisations. Linking back to the point above, it is only when the value of good budgeting information is understood that an informed decision can be made about making the investment this additional analysis requires.

Active talent management

The final point to be made in respect of budgeting resources relates specifically to the 'people' agenda. In particular, actively managing talent in the Finance function (as in other parts of the organisation) is critical, covering staff development and succession planning. A broader element coming through from the research is the need to integrate Finance with the rest of the organisation to ensure that Finance has a detailed understanding of how the organisation operates. Therefore when key finance staff leave the organisation, it is losing not just the technical skills (which can be hired from elsewhere) but also organisational knowledge which can take many years for even the most talented recruits to learn.

Conclusions

Resources being allocated to Finance are being significantly reduced at a time when financial skills and expertise should be at a premium. Successful organisations tend to have a Finance function closely integrated with other divisions/ directorates in the organisation. One approach to deliver this closer integration is 'Business Partnering'.

Not specific to the case study group, but from wider observations, there seems to be a gap in organisations' understanding of the value of good budgeting. However, moving forward, this represents a significant challenge to Finance functions to articulate and demonstrate the value of good budgeting information (e.g. in terms of increased efficiencies and improved information for strategic decision making).

Linked closely to the 'value' of good budgeting, is the increase in analysis activity over data capture activity. Given current financial pressures it is likely that resources for additional analysis are only going to be found from further efficiencies in 'transactional' activities.

Finally, it is intuitive to suggest a correlation between talent in the finance function and 'good' financial outcomes derived from data analysis (as distinct from data capture). This in turn would suggest a strong case for 'talent reviews' particularly in times of financial constraint.

[2] PricewaterhouseCoopers: Putting your business on the front foot: Finance effectiveness benchmark study 2012

4. Prioritising Expenditure

Introduction

Prioritising expenditure and making difficult decisions is the norm for all organisations in our case study group, across both the public and private sectors. Exploring the issues which arose from the research has been structured as follows:

- Prioritisation criteria typically used;
- Observations from the research; and
- Conclusions.

Prioritisation criteria typically used

The research identified a remarkably similar range of prioritisation criteria across the different sectors. Typically these were:

- Statutory/ Regulatory activities – always the top priority in both the public and private sectors;
- Alignment to strategic objectives and priorities – only programmes/projects/services that are aligned to the strategic objectives would be approved/ prioritised;
- Enhancing service delivery/ customer experience;
- Increasing value – either shareholder value or value to the taxpayer; and
- Risk associated with a project – higher risk projects would require a higher expected return to be prioritised.

The standard budgeting process of each organisation takes into account the above criteria in prioritising expenditure according to need in their particular environment. In recent years, reflecting the financial constraints, there has been an emphasis in the public sector on reducing expenditure and less choice in the prioritisation of expenditures once statutory requirements have been met.

Observations from the research

Although the high-level criteria are similar across all sectors, there were some interesting observations which were specific to individual sectors and in many regards reflect the environment of those sectors.

Consultation

Managing cost reduction is a big issue for Local Authorities and one of the primary approaches they have taken to inform their prioritisation process is extensive public consultation. One Local Authority analysed has developed a very structured and comprehensive consultation process to understand the public's views on priorities for non-statutory services (see case study below). The Council considers that this helps to secure public buy-in for difficult spending decisions but recognises the very significant risk of consultation fatigue if this type of exercise is repeated on an annual basis. Therefore if further rounds of tough spending decisions are required, alternative approaches to engage with the public and maintain their buy-in will have to found.

Case study finding – Towards authentic public consultation

One of the councils in the research developed a four stage consultation approach for their 2012-14 strategic budgeting exercise. The communication channels included the Quarterly Publication, website, media releases and internal newsletters. This comprehensive approach successfully engaged with over 4,500 individuals, compared to previous online surveys which only achieved response rates of 2,000.

- **Phase 1:** Informing (residents, business, councillors, employees and other partners) on the services which would be provided and research finding on resident's attitudes to Council spending.
- **Phase 2:** Consulting stakeholders through a budget survey launched via the Council's consultation portal to obtain the public's views on which non-statutory services should be prioritised. Importantly, the impact of the choices was communicated to the public to support this process.
- **Phase 3:** Engagement with targeted/specific user groups of services which were identified to be altered, discontinued or delivery model changed. Each engagement was undertaken on an individual basis.
- **Phase 4:** Feedback from the consultation was used to inform the budgeting process and this was transparently communicated to all participants and the wider public.

Top-down approaches taken internationally

The international case studies highlighted a number of top-down approaches imposed by Treasury/ Finance Departments which drives the need to prioritise. In each of the 3 countries examined, the following approaches are taken:

- Australia has an "**Off-setting Rule**" – where the additional expenditure associated with a proposed new policy must be off-set by a reduction in expenditure in an existing policy area.
- In Germany a "**Debt Brake Rule**" has been introduced which requires the Federal Government to move towards a 'near balanced' budget by 2016 (the fiscal deficit is not to exceed 0.35% of GDP).
- In Canada each Department is required to set out options for identifying savings of 5% and 10% from Operating Expenditure over a 3-year period.

Financial Return – typically applied by the private sector

The private sector, unexpectedly, places significant importance on financial return analysis to prioritise expenditure. The following examples were taken from the case studies:

- The natural resources company (using the Beyond Budgeting approach) focuses on profitability and does not prioritise expenditures to achieve this;
- One UK based company, has four metrics for prioritising expenditure: top line Revenues, Profits (EBITDA), Net Cash Flow and Headcount reduction (all projects are required to have a positive impact on at least one of these four key metrics);
- Another UK company considers business opportunities as and when they arise and will switch expenditure if a strong business justification exists. This flexible approach means that management is not constrained by the budget.

Conclusions

Overarching governance processes such as the 'off-setting rule' and the 'debt brake rule' are seen as good tools to enforce budget and expenditure responsibility and have proved successful in the countries in which they have been applied. Interestingly, this approach contrasts with the greater flexibility and freedom now being seen in the private sector.

This however, must be seen in the context that the private sector has much greater scope to increase spending if it delivers a greater financial return. This additional expenditure can generate increased profits and can therefore be self-financing (potentially in-year).

The public sector is much more restricted in terms of being able to generate revenue from additional activities and although 'spend to save' initiatives follow the same principles, the pay-back period is typically longer term. Furthermore, firms have greater flexibility in terms of changing in-year financing decisions, which in the public sector tend to be made as part of an annual cycle. As a result this is a potential learning point for the public sector.

Finally, it is important to recognise the significant difference between prioritising expenditure and making efficiency savings. Prioritising expenditure is ultimately about achieving 'less with less' whilst efficiencies is about achieving the 'same (or more) with less'. This is explored further in the next section of this report.

5. Finding efficiencies

Introduction

Due to the financial pressures of recent years, achieving efficiencies has become an increasing priority for senior management and the budgetary process is integral to the achievement of these efficiency savings. The research, particularly from the public sector, had a number of common themes in emerging and these included **transformation programmes** and **efficiency reviews**, **benchmarking** exercises and simply '**knowing the organisation**'.

In terms of achieving efficiency gains, the single most common approach adopted focused on **collaboration**, both in terms of internal organisational collaboration across divisions/ departments and also between organisations.

The **top down directive** was also a common feature of how organisations were driving efficiencies - i.e. determining a target cost reduction level and requiring line management to identify plans to achieve the efficiency. This approach was most commonly observed at the Treasury/ Finance level in Central Governments, particularly in reaction to the current economic climate. Many Local Authorities are also experiencing this through significant reductions in their central funding (which is driving de-prioritisation).

Observations from the research

There were a number of interesting observations taken from the research in respect of some of the approaches above and these are discussed below.

Collaboration

It was recognised that collaboration between divisions/ departments within an organisation is important for the provision of efficient services and for preparing a budget that is robust at the organisational level which resolves cross-departmental inconsistencies. Furthermore, the case study participants noted that collaborative working supported a 'good corporate behaviour' culture across the organisation. In addition, collaboration across organisations commonly manifested itself in the establishment of shared service centres for the delivery of both back and front office services.

Although not related to efficiency savings, it was interesting to note that local bodies such as police authorities, strategic health authorities as well as Local Authorities are required to work together to address complex social problems. Often these issues can only be properly resolved by taking a multi-agency approach. Therefore collaborative working not only delivers efficiencies but can also increase quality of service delivery.

Local Authorities have developed a number of collaborative working groups to explore ways in which they can work more closely together (see case study finding below).

Case study finding – collaborative working groups

The Society of London Treasurers (SLT) consists of the finance directors of all 33 London authorities and is used by senior finance staff to network and share learning across London Boroughs. The group has also established a number of projects to identify how savings and efficiencies may be achieved either within organisations on an individual basis or working collaboratively.

An example of one proposal being developed is for London authorities to share financial and HR systems, in a bid to make substantial savings. It is estimated that savings would come through reduced procurement costs, improved relationships and negotiating positions with key finance system suppliers and reduced costs through more efficient processes.

Other similar groups exist at the Local Authority level including the Society of Municipal Treasurers (SMT) and the Society of Unitary Treasurers (SUT).

Internationally, Australian Public Services (APS) 200, is a group of the most senior public officials across Government, which has been established to identify areas where efficiencies could be made.

Benchmarking

Benchmarking is one of the many tools used in undertaking efficiency reviews and also helps managers get to 'know their organisation'. Benchmarking also requires collaboration and is consistent with broader activities in the Local Authority sector. One Local Authority in the case study group benchmarked its IT function against peer groups (through the Society of Information Technology Management, SOCITM) and as a result of this exercise it was able to identify (and realise) efficiencies of 30%.

International Experiences

The international case studies also highlighted a number of interesting approaches to finding efficiencies.

- Shared Services – in Canada a number of steps have been taken to drive forward the shared services agenda including: allowing Central Government Departments to sell internal services to each other; and the creation of Shared Services Canada, a single organisation created to provide back office services to Central Government;
- Efficiency Dividend – Australia has introduced the concept of the 'Efficiency Dividend'. This requires Central Government Departments to find annual efficiencies of between 1.5% and 4% on their departmental expenditure (similar to Resource DEL in the UK);
- 'Offsetting Rule' and 'Debt Brake Rule' discussed above is also an important disciplinary framework for encouraging the identification of efficiencies.

An important lesson learned in one case study country relates to the **exclusion of capital costs** from efficiency targets. In previous efficiency programmes, the inclusion of capital costs had led to unintended consequences, such as reducing capital maintenance expenditure which resulted in cost increases in the long run.

Conclusions

True efficiencies represent either a reduction in cost without a negative impact on service delivery/ quality or an improvement in service delivery without an equivalent increase in costs. Therefore achieving 'true efficiency' remains the elusive goal of all senior managers. However, in practice, the case studies have shown that whilst many Local Authorities have delivered efficiencies, funding constraints are also having an adverse impact in the delivery of services.

One of the key findings from the research indicated that efficiencies are delivered and identified through in-depth knowledge of the organisation and undertaking detailed analysis of spending areas. Therefore the provision of high quality **financial insight** is an important component in the delivery of efficiencies to an organisation. As noted previously, public sector organisations are becoming more efficient in the processing of transactions (e.g. through increased use of shared service centres) and therefore the potential exists for Finance functions to re-direct at least some of the time/ resource released to providing high quality analysis and insight. This could be an important facilitator for identifying further service efficiencies.

The primary approach to delivering efficiencies across the case study group has been increased **collaboration**. This has been particularly evident across the Local Authority group but also seen in some international case studies (e.g. Shared Services Canada). The main focus of collaboration witnessed to date has been in respect of **back office functions**; however there is a trend starting to emerge in terms of collaborating on **front office services**. This could potentially represent the next phase of collaboration for public sector bodies.

It is clear that efficiency drives are almost always driven from the **top-down** (e.g. an efficiency review is commissioned and/ or specific efficiency targets are set) and in the case of Local Authorities in our case study group, it was the result of significant funding constraints imposed by Central Government. Furthermore, our international case studies revealed that countries which imposed strict spending constraints (e.g. through the 'Debt Brake Rule' or the 'Off-setting Rule') benefitted from relatively strong fiscal positions.

The international research also highlighted lessons learned around the type of expenditure which should be identified for efficiency savings. In particular, attempting to find top-down efficiency savings from capital budgets is high risk and can lead to greater costs in the longer term.

In the private sector research, the approach to finding efficiencies appeared to be an ongoing exercise and all initiatives/ projects are assessed in terms of their contribution to profit. Therefore spend to save initiatives and restructuring projects would be assessed using the same financial criteria as other projects and decisions made on that basis. Although not witnessed in the private sector case study group, it is possible that in times of high economic growth, expansion projects offer the greater financial return and then in times of low economic growth efficiency projects off the greater financial return.

6. Using Performance Information

Introduction

All organisations which took part in the research had performance management processes in place to support the preparation of the budget and to manage performance against the budget. However, it was acknowledged that interpreting performance information was a difficult area, particularly in the public sector, where contrasting conclusions could be reached from the performance information. In addition, many of the case study participants indicated this was an area which needed further work and there were a number of areas for improvement.

Managing Performance

Managing performance concerns how organisations and individuals are encouraged and incentivised to strive to attain the targets set for the year. The two key aspirations identified were to align individual performance with organisational performance and using a consistent approach across Government. In addition the case study candidates highlighted a number of areas for improvement.

Aligning individual performance with organisational performance

A feature much more prevalent in the private sector case studies was the recognition that the performance of the organisation as a whole does not always map exactly to individual managers' performance targets. Therefore to promote good corporate behaviour, organisations now focus on recognising and rewarding group performance rather than local/ individual performance.

- One case study company based its performance bonus system on corporate profit and cash targets. Sectors are measured against the circumstances which prevailed during the year rather than how they compared to budget. The intention is to take unknown factors out of the performance assessment and to be fair with people. Furthermore, there is a collective approach to meeting the corporate objectives and budgets, where all managers have a responsibility to address any gaps when outturn falls behind the level planned.

- Another company uses a balanced scorecard approach in which performance evaluation is a holistic assessment of delivery and behaviour. Similar to above, the focus is on relative rather than absolute performance, and they do not set an absolute percentage target for Return on Average Capital Employed ("RoACE"), but to be in the top 25% relative to other selected companies.

- Another case study reviewed the effectiveness (as determined by accuracy of forecasts) of cascaded budgets into budget-holders' personal scorecards. They discontinued this approach as it encouraged sub-optimal behaviours (e.g. hidden contingencies and increased discretionary expenditure towards the end of the year). Under the new approach each division now has a performance scorecard that will monitor compliance with the budgetary process (e.g. budgets submitted on time, all information supplied etc.). In addition, budget-holders' personal scorecards are then linked to the overall performance metrics.

- In Canada, the Management Accountability Framework (MAF) performance management tool is used to support accountability of Deputy Heads (equivalent to UK Permanent Secretary) and improve management practices across Departments. All major Government Departments and a proportion of smaller agencies are assessed on an annual basis across 14 'Areas of Management' (such as: people management, financial management and asset management.) The results from the MAF assessments are used as an input in the Performance Management Program for Deputy Heads.

Using a consistent approach across Government

Whilst individual organisations may have comprehensive performance information at the micro-level, the international research highlighted an issue around the consistency of performance information at the macro-level (i.e. across departments). This includes consistency in terms of both the comprehensiveness of performance measures across organisations but also the quality of the performance information captured.

Canada is recognised internationally as being more advanced in its use of performance information in the budget preparation process. This is explored further in the example below.

Case study finding – consistent reporting of performance information across Government

The Canadian Treasury Board Secretariat's *Policy on Management, Resources and Results Structures (MRRS)* supports the development of a common government-wide approach to the identification of programmes and to the capture and management of financial and non-financial information relative to those programmes. This policy is implemented in a number of ways including the Program Alignment Architecture (PAA) (and the Management Accountability Framework (MAF) discussed above).

Program Alignment Architecture (PAA)
The PAA is a common framework or template completed by all Government Departments which sets out the following:

- Strategic Outcomes of the respective Department.
- Alignment of the Programs and Activities undertaken by each Department to the Strategic Outcomes.
- Financial and non-financial performance information.

This is collated by the Treasury Board Secretariat (TBS) and allows for a strategic/cross Departmental review to inform budget allocations.

Areas for improvement

All case study candidates recognised that the use of performance information in the preparation of budgets was an area for improvement. This covered a number of points, including:

- There are gaps in understanding the full cost of delivering individual services. In these instances, costs for delivering services are typically held across a number of cost centres/ divisions resulting in a lack of clarity;
- Even where costs are understood at a departmental level, there was much greater scope to improve clarity at the horizontal/ cross-departmental level. This in turn should facilitate the identification of cost duplication and hence scope for further efficiencies;
- There are often gaps in the Performance Information collated and a lack of consistency of definitions making comparisons and benchmarking activity difficult (a problem the PAA in Canada discussed above is seeking to alleviate);
- Interpreting performance information can also be a challenge in terms of how it informs budget allocations. For example, should poorly performing areas receive more or less funding?

Conclusions

Effective performance management is a combination of: good performance information; performance measurements that effectively stimulate and measure performance; and a performance appraisal system that is fair and recognises that circumstances can change over time.

There were a number of key principles in respect of managing performance and encourage good corporate behaviour:

- clearly articulated goals and performance objectives;
- staff buy-in to goals and objectives; and
- clarity around how individuals contribute to achieving objectives.

Research from the private sector case study participants has revealed companies have learnt from experience and are putting in place performance regimes that are more relative than absolute in nature and reflect reality as it happened rather than a notional target set 12 months prior.

Furthermore, it is becoming more common for organisations with an advanced financial management culture to place more trust in their staff to make the right decisions. The view is that they are best placed and have the most information to make these decisions. The quid pro quo for this additional trust is robust sanctions if that trust is breached.

The research highlights the use of performance information as one of the key areas for improvement in the budgeting arena. Canada is recognised as being at the forefront in this area and has developed an architecture which other countries and sectors could learn from.

7. Relevance to Central Government

Introduction

The research was undertaken across a number of UK Local Authorities, UK private sector (either UK based or significant operations in the UK) and Central Government (Dept of Finance/ Treasury equivalent organisations) in Australia, Canada and Germany. This final section of the research report considers the relevance of the findings to the UK Central Government and/ or how some of the learning could be applied.

Budgeting framework

A key theme emerging from all the case studies has been a move towards **tailoring the budgeting methodology to fit the business/ operating environment rather than forcing the business to change it management decision making to fit the budgeting method**. This has been most evident in the private sector but there have also been examples of this practice in the public sector.

This is reflected in the growing practice of setting the annual budget in the context of a medium term rolling budget. The medium term budget reflects the fact that expenditure decisions often have a longer term impact than one year and this must be reflected when creating budgets. In addition to this medium term budget, the Australian Government also produce a very long term 40-year inter-generational report. In contrast, the natural timeframe of the natural resources business can vary considerably depending on the particular area of business and tends to be related to events so it has introduced flexible event-based budgeting.

Many activities within Central Government have a natural timeframe beyond one year and this is reflected to some degree in the UK where the governance environment is focused on in-year spend within a three year Comprehensive Spending Review (CSR) period and has relatively strict end of year rules. Therefore the current framework could potentially encourage sub-optimal behaviour and constrain efforts to make the best use of resources. There would appear to be opportunities to consider how some of the practices examined could be adopted to achieve better results. This may include the introduction of rolling longer term budgets and more flexible end of year budget rules.

The "Beyond Budgeting" approach is very radical and clearly challenges conventional budgetary thinking. However there are a number of interesting components which, with some tailoring, could work in even the most conventional of organisations. One example could be devolving greater budgetary responsibility to local management and a second could be use of relative target setting. This may not be practical across all of Central Government, but awarding greater budgetary freedom to meet relative KPIs (e.g. top quartile) in areas of limited spend could alter behaviours and encourage ownership and innovation.

Budgeting methodologies

The approaches to creating the budget in the UK is not significantly different from the process adopted in the other countries examined. In Central Government a number of approaches to budget development are currently adopted ranging from the traditional incremental approach to more sophisticated approaches, such as the use of demand analysis and detailed one-off investigations. Given the UK is facing greater fiscal constraints than the countries examined in the research, it could be argued that it needs to move further away from incremental towards a more sophisticated budgeting approach in order to identify further savings.

The UK Government addresses many varied activities from defence to welfare provision through Departments, controlled centrally by HM Treasury. This is similar to the private sector where many large organisations have a Group function with devolved responsibility to operating divisions. However, in contrast to the public sector, the levels of granularity of spend set out by Group functions varies greatly, dependent on the levels of authority and local entrepreneurialism and innovation required. In short, a 'one size fits all' approach is not necessarily appropriate across all of Central Government given the broad scope of activities undertaken. Some areas for consideration in developing budgets could include:

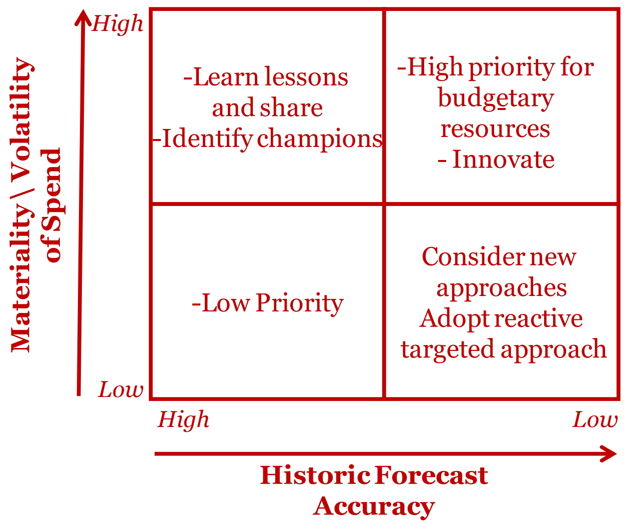
- Detailed demand analysis – depending on the specific area of expenditure this could be based on a wide range of statistical data such as economic conditions; demographics; and educational attainment;
- Changing timeframes – some expenditure areas would typically operate on long-term time frames and others on much shorter timeframes, therefore increased flexibility, where appropriate, should be considered.

Allocation of resources to budgeting activities

Some areas of Government expenditure will be relatively static from one year to the next and as a result forecast accuracy should be high. Similarly, other areas of spend will be much more volatile and therefore more difficult to forecast. As a consequence, the effort expended and approaches used in developing budgets should vary depending on the volatility and historic accuracy of the different budget lines.

One of the case study participants developed the following framework to estimate where effort should be devoted during budget development. This Budget Effort Prioritisation Matrix is set out below.

Figure 1: Budget Effort Prioritisation Matrix



This matrix analyses the budget across two dimensions:

- **Materiality/ Volatility** – how material/ volatile is the revenue or expenditure line? E.g. revenues from an existing product may be relatively stable, whereas new products are highly volatile and dependent on the success of marketing campaigns;
- **Forecast Accuracy** – how effective has management been in forecasting revenue/ expenditure areas in the past?

Greater effort is prioritised in the areas which have historically been volatile and forecast accuracy is low. Furthermore there is potential for organisations to identify areas of good practice and through learning share the good practices.

Finally, this matrix analysis can also be used to identify areas where **efficiencies** could exist in the budget development process. This is more likely in a Group structure where no single person has oversight of the detailed activities being undertaken across a number of divisions, but it is possible that in some cases significant resources are devoted to budgeting expenditure areas which have low levels of volatility, have been historically accurate and not material to overall organisation. In these instances budgeting resources could be reallocated to other budgeting/ financial tasks.

Prioritising Expenditure

The research showed both the public and private sectors applied similar criteria to prioritising expenditure (i.e. mandatory/ statutory spend; alignment with Corporate Plan/ Manifesto commitments; enhancing service delivery and increasing value). These criteria are also used to prioritise the majority of Central Government spending. In terms of potential lessons for Central Government, the following points could be considered:

- Encouraging "spend to save" projects/ initiatives to allow innovative managers to find new ways of delivering services more cost effectively;

- "Offsetting rule" – this puts a significant discipline on Departments to fund new policies out of savings from existing expenditure, however it probably creates a bias towards promoting the 'Status Quo'; and

- Increased flexibility at an overarching governance level in terms of budgetary rules would help to ensure that the rules do not frustrate the implementation of good ideas (however this contrasts significantly with the 'Offsetting Rule' above).

Efficiency

The primary driver for efficiency identified in the research is around increased levels of collaboration, primarily through the sharing of services. This is also a feature of activity in other countries with Shared Services Canada (a single back office shared service across all of central government) being the obvious example.

UK central government is already undertaking a range of collaboration initiatives but potential areas for further consideration could include:

- The emerging trend to share front office services – this may present greater challenges for Central Government as each department delivers different services, but identifying synergies between similar types of service should be explored;

- Common purchasing.

In addition to increased levels of collaboration, one key area identified which could potentially result in increased efficiencies was improved costing information on a cross-departmental basis. This increases scope for identifying duplication of costs and together with increased collaboration, increases the scope for efficiency.

Use of performance information

Using performance information has been acknowledged by all public sector case study participants as an area for improvement. In particular, there is a lack of understanding in terms of how to interpret and use performance information in the budget allocation process (e.g. if education services are under-performing how should this information be used to determine the level of funding allocated?).

Nevertheless some potential lessons for UK Central Government in the use of performance information and managing peoples' performance include:

- The use of a common language and performance architecture across all of Central Government (e.g. the Canadian Programme Alignment Architecture (PAA);

- Creating a culture where managers are empowered and performance is assessed fairly:

  – Performance targets are set on a relative rather than absolute basis against a selected peer group (e.g. to achieve a performance level in the top quartile (25%));

  – Individual performance is more closely linked to group targets rather than individual targets (as this can result in sub-optimal corporate behaviours);

  – Put increased trust in managers to make the right decisions where they are better placed and have access to more information than those working in the centre. The quid pro quo for additional trust is robust sanctions if that trust is breached.

Conclusions

It is clear that the challenges and pressures for Central Government are increasing with less funding available and, for many Departments, greater demands on their services. The traditional budgetary regime of fixed budgets for a fixed period and a "spend it all" culture are not appropriate for the current financial environment. Government is responding to the challenges and there is greater flexibility now than previously, however issues remain in the budget framework that are a constraint to good budgetary behaviour. Although in progress, perhaps there is more to do to move away from the "fixed and rigid" regime of the past to the "agile and flexible" regime emerging to manage government finances in the future.

The private sector has been developing new approaches with companies now looking to improve the budgeting environment and process. The main areas progressed have included:

- Aligning the budgeting process to the business through the application of rolling budgets; budget timeframes matched to the business timeframe; and flexible rules that encourage good budgeting and corporate decision making;
- Encouraging innovation and rewarding enterprise through 'spend to achieve' initiatives;
- Improving the budgetary process through basing the budget on what drives expenditure in the organisation and integrating the impact of these main budget drivers across the business;
- Demanding responsibility from its managers and "good corporate behaviour" through the use of holistic and broader corporate targets rather than individual targets;
- Developing appropriate performance measures which reflect the 'reality on the ground' and incentivise optimal behaviours; and
- Developing a management information system that delivers relevant accurate information for decision making.

Public sector bodies have also started moving in this direction. Internationally there is evidence of governments encouraging spend to save, budgeting over longer periods, using rolling budgets and reducing the significance of the financial year end through more flexible rules. Local Authorities are also starting to look at improving budgetary processes driven by the cuts in finance being applied.

However, as stated in the introduction there is no "silver bullet". The budgetary process is a complex mix of environment, rules, practice, values, people and behaviours that changes constantly and requires continual effort and work to improve. A successful budgeting solution requires integration and coherence across all these factors and to effect a significant improvement in budgeting requires consideration of how many of these factors could be improved in tandem.

Lastly, now is a good time to tackle these issues, the financial crisis continues and there is no immediate prospect of an easing of fiscal constraints. A stepped change to the budgeting process across UK government could help to ease the burden and facilitate the road to recovery.

Appendices

- Appendix A: Topic guide
- Appendix B: Case studies
- Appendix C: Bibliography

Appendix A: Topic guide

National Audit Office

Interview question guide: Good Budgetary Processes: Comparators

Interview Question Guide

We have developed a series of questions to assist with the capture of budgetary information about your organisation. Where possible please provide documentary evidence that will help substantiate our discussion and contribute to the production of the actual case study.

General information

Organisation Name				
Date				
Location				
	Name	Title	Role	Other
Interviewee 1				
Interviewee 2				
Interviewee 3				
Interviewee 4				

	Organisational context (Approx 5 mins)
1	Can you **briefly** describe your organisation and the current financial challenges you face? • Are you in a Growth phase? • Are you in a Cost Reduction/Consolidation phase? • Are you in an Organisational Change phase? What broad approach is employed to manage/deliver this current phase?

A.	**Budgetary process (Approx 10 – 15 mins)**
2	What is the governance structure around the budgetary process? • Discuss the following budget stages: – Budget Preparation stage – Budget Review – level of challenge and scrutiny – Budget Approval • Is the budget process bottom up or top down or both? And can you give an example as to how this works in practice? • How are external stakeholders brought into the process? • What is the level of internal and external challenge and scrutiny of budgets? How is this undertaken? • How long is a budget planning cycle?
3	What budgetary approach do you use? Does it differ between Capital Expenditure and Resource Expenditure? E.g. • Incremental based budgeting (Budgets prepared based on historical data/prior year's actuals); • Zero-based budgeting (start with a clean slate/no historical data); • Performance Based Budgeting (PBB) (Result orientated planning and budgeting); • Driver-based budgets (for example net new user/customer's drives customer services budget); • Other. What difference has your budgetary approach made to any key challenges your organisation has faced in recent years?
4	How does financial/budget planning link with operational planning? • At what levels are budgets prepared (organisational, divisional, business unit, project, activity and product/service)? How much detail is provided at each level?
5	How is the final budget communicated across the organisation and externally?
6	Is there a dedicated budgeting function within the overall Finance function? • What is the approximate level of resources devoted to budgeting (FTEs as a % total Finance function FTEs)? Any views on what the optimum level of dedicated budgeting resource should be?
7	How do central government planning and budgeting processes support effective business planning at your council? What more could they do?

B.	**Budgeting and spend prioritisation (Approx 40 mins)**
8	How is spending prioritised where there are competing demands for funding? • How do you rank/prioritise budget allocations? • What factors impact ranking (rate of return, risk, capacity, political decision)? • Does your organisation consider prioritisation across its entire portfolio of expenditure or is spending prioritised on a divisional/unit basis? • How does financial management and operational management work together in this process? Have you any examples? What works best in your organisation and why?
9	What analysis techniques do you use to prioritise funding? • Financial – e.g. Payback period/ ROCE/ NPV/ IRR • Non-financial – e.g. demand for service, political preference, performance against objectives • How do you reach a balanced decision between financial and non-financial factors? • How do you decide which technique to use? What works best in your organisation and why?
10	How does the prioritisation process differentiate between different types of expenditure? How are the different approaches managed when different elements of project spend are brought back together? • BAU versus Special projects (e.g. Cost reduction projects/ Spend to Save initiatives); • Capital Expenditure versus Resource Expenditure; • Core versus discretionary spend. Have you any examples? What works best in your organisation and why?
11	What information and reports do you use to support this decision making? • What information do you capture and report? • What are your views on the quality of information available to you to prioritise spend? • Where are the most common gaps in information?
12	How is the budgeting process used to reduce costs? • What are the barriers which impede cost reduction (e.g. silos and ring fencing of funding)? • How can the budget process enable cost reduction initiatives? How do you budget for 'cost to save' projects? • Approx. what is the typical annual % investment made on cost reduction/efficiency programmes?
13	How do you encourage good corporate behaviour across your budget managers/ departments? • What incentives do you have to encourage good behaviour in the budgetary process? • What happens to surpluses or deficits? When are these identified? • Is there Re-planning, Return to centre or Gain share?
14	What factors support your ability to deal with financial cuts and changing financial circumstances?
15	How are interdependencies managed between divisions within your organisation?
16	What is your process to manage the flexing of budgets in-year following changes in circumstances? • What are the triggers which result in a flexing of the budget? • What strategic approaches do you use to manage this? • How often is this undertaken? • What information is used to inform the flexing of budgets?
17	Can you give us an example of a budget prioritisation issue you had and how it was resolved?
18	How does central government support your council's ability to respond to/manage financial pressures? What more could they do?

C.	Linking Strategic Planning and Performance to the budgeting process (Approx 30 mins)
18	Is there a link between your strategic planning process, performance management and the budgeting process? • How are strategic objectives used to inform the budget setting process and to prioritise expenditure?
19	How do you link performance into the budgeting process? • How is performance used to help prioritise expenditure? • Is it only used in specific areas of spend/ activity? • How does the initial funding allocation link to previous performance? • Is there a process to monitor/ manage performance throughout the year (e.g. would funding be reallocated from poor performing areas to higher performing areas?)
20	What performance management information do you use to support decision making? • What are the main Key Performance Indicators (KPIs) you use in setting and managing your budget?
21	What are the key factors to consider when introducing performance management into the budgeting process?

Appendix B: Case studies

International Government case studies

- Australia
- Canada
- Germany

Private sector case studies

- Large UK PLC
- Natural Resources Company
- Large UK Utility
- Multi-national Engineering Group

Local Government case studies

- Coventry
- London Borough of Croydon
- Gateshead Council

Background

Economy has not experienced a recession partly helped by the resource boom

Close to balanced budget

Incremental Budgeting Approach

Australia - summary findings

- ***New funding initiatives put forward by Ministers are expected to be offset by reductions in existing expenditure***
- ***Forward estimates are prepared over a three year period therefore spending decisions considered over a 4 year period***
- ***1.5% efficiency dividend / saving target on administration expenditure which is ongoing and continuous***

Macro – economic environment

The Australian macro-economic environment is very strong relative to Western European economies. The country avoided recession during the Global Financial Crisis (GFC), inflation is under 3%, economic growth is about 3% annually in real terms and unemployment is around 5%. Government debt levels are very low. The economy's strong performance is underpinned by strong demand for Australian resources from Asia, a strong banking system and government economic stimulus during the GFC. The economy is however undergoing structural pressures and changes, with a historically high exchange rate, and uneven performance in different sectors.

The country entered the global financial crisis operating a budget surplus but with the global economic slowdown, stimulus measures to alleviate its impact and a series of natural disasters the budget has moved into deficit. The current deficit level is approximately 2.5% of GDP, but the Government's stated intention is to return to surplus in 2012/13.

In Australia's federal system, the larger part of taxation revenue is collected at the centre. Around 30 per cent of federal spending takes the form of tied or untied payments to state governments for spending through their own separate budgets. Apart from defence, the bulk of capital spending occurs at state level.

The budget process

Economic analysis work is undertaken to review the current and forecast economic position. This is performed against the backdrop of Cabinet's strategic objective in respect of the level of deficit or surplus they are targeting and other strategic policies.

The budget sets out a Medium Term Expenditure Estimate. This constitutes a four year rolling outlook with detailed expenditure plans for Year 1 (the budget year) and forward estimates for each of the following three years. The Medium Term Expenditure Estimate is then updated in a mid-year review and again in the next annual budget.

As many decisions have multi-year impacts, the financial impact of all spending decisions are identified across at least this 4 year period.

Separately, a longer term (40 year) analysis and projection is issued approximately every three years in the form of an Intergenerational Report with a focus on long term demographic pressures and other projected developments.

The experience of the Department of Finance and Deregulation (Finance) is that the rolling multi-year outlook and analysis is a good discipline as it requires consideration and disclosure of the longer term consequences of spending decisions to be identified.

The budget process makes an important distinction between existing policy and new policy.

"If Ministers want to finance new programmes, they have to offset against expenditure in their existing budget.

This makes the system more self regulating. It gives Ministers flexibility while helping to keep the budget balanced."

- Existing policy – this is the set of current policies and decisions which make up the base budget e.g. entitlement expenditure or ongoing fixed grants or subsidies.
- New policy – new spending proposals developed by a Minister in respect of a new policy or expansions of existing policies or programs.

There is also a further distinction between administered expenditure and departmental expenditure.

- Administered – spending on program delivery;
- Departmental – spending on the administration of government.

Off-setting Rule

When a new policy is proposed by a Department or its Minister, the additional expenditure is required to be 'off-set' against a reduction in expenditure elsewhere in the Department or (less likely) in another Department or offset by extra revenue. Reductions in administered spending may occur through adjustment of parameters such as for indexation, changing eligibility for entitlement, programme participation or cutting cash amounts for fixed grant or subsidy programmes.

Efficiency dividend

In addition to the 'off-setting' rule, departments also have an efficiency dividend to meet in respect of departmental spend (but not administered spend).

A percentage reduction is made annually at a minimum of 1.5% (2012 4%) across all Departments' own departmental spend. The deduction is made in advance from allocated departmental budgets and each Department is required to develop efficiency measures in order to derive the required savings to manage within the lower amount.

Expenditure Review Committee

The overall budget process is overseen by a sub-committee of Cabinet called the Expenditure Review Committee (ERC). The ERC comprises the Treasurer, Finance Minister, the Prime Minister (when present) and a small number of other Senior Cabinet Ministers.

The ERC is responsible for challenging and reviewing the budget proposals submitted by each of the line Ministers. Following this review and challenge, budget recommendations are made to the full Cabinet. The ERC also reviews taxation and revenue proposals.

It is Finance's view that this process works well.

Budgeting approaches used

- Incremental – the primary budgeting approach is based on the distinction between existing policy and new policy, with only existing authorised policies and programs forming the baseline position. Estimates for entitlement programs are updated according to the estimates of demand from recipients and the approved set of entitlements, and indexation factors, while 'fixed dollar' programmes remain in the baseline at their authorised levels, adjusted in some cases by agreed indexation factors. All proposals for new spending are separately handled through the ERC's new policy examination process, along with the offsets that are required to be identified.
- Zero Based Budgeting (ZBB) – Whilst ZBB may be appropriate for capital expenditure at the individual project level, and for new programs that are being proposed, at the macro-level the incremental approach of an existing policy baseline and a bidding process for new policy is used.

"We want performance to be more integrated into programmes.

We want the measures to inform the process and help to make the program delivery better."

- Performance Based Budgeting (PBB) – although performance results do not directly drive budget allocations, performance information is used to inform the budget development process. The quality and relevance of available performance information varies and performance information is just one of the factors used to facilitate good decision making, with others being policy priority and coherence with strategic directions of government. If a programme is seen to be performing poorly, this could be an implementation issue rather than necessarily a justification for reducing expenditure. In these instances a review of delivery arrangements may be required or a transfer between projects/ programmes which are delivering on the same priorities.

- Driver Based Budgeting (DBB) – as described above, this is used to refine the base expenditure/ inform the incremental adjustments to the baseline position through the development of demand based models for a range of programme expenditure areas (e.g. care related expenditure and unemployment payments).

How spending is prioritised

The starting point is the current Baseline (i.e. Existing Policy expenditure). Then after some preliminary guidance to Ministers on the overall budgetary circumstances and priorities, a two step process typically follows:

- Step 1: Each Departmental Minister identifies a 'longer list' of new policy proposals, usually in priority order.

  ERC usually then ranks and sifts these proposals based on Government priorities, affordability and suitability, to identify a shortlisted subset of proposals.

- Step 2: the shortlisted proposals are developed in detail BUT each Minister is also required to identify off-setting expenditure reductions.

Funding prioritisation may also occur through variations in the level of savings targets that may be applied across Departments. So an area which is considered a higher priority may be given a lower savings target (and vice versa).

Savings targets and offsetting requirements act as a discipline on Line Ministers and Departments to prioritise their expenditure.

Information used to support decision making

Minister or Cabinet commissioned reports/ reviews on specific areas of activity are frequently used by the relevant Line Minister and Department to inform their budget and justify spending proposals.

Line Ministers and Departments are required to understand and describe the impact of new proposals across different groups in society (a type of Equality Impact Assessment), the impact on families and the impact on the regions.

In addition new proposals are required to consider implementation risks and capacity issues.

Supporting cost reduction through the budgeting process

The Australian Government has also identified a number of Whole of Government savings initiatives in addition to the annual efficiency dividend. Finance is responsible for developing and implementing a number of efficiency measures such as coordinated procurement in specific areas such as: Major Office Machines; IT; and travel; and other measures such as a common approach to managing office space.

Encouraging good budgetary behaviours

Encouraging senior decision makers to put the 'Whole of Government' interest before that of their own Department is done in a number of ways including:

- Political level – the Cabinet take collective responsibility;
- Official level - financial management legislation requires officials to take account of broader government policies and priorities, the heads of Departments are appointed by the Prime Minister on the recommendation of the head of the Prime Minister's Department and the heads meet regularly as a Secretaries Board to consider service wide issues. Further, the Australian Public Service Commission encourages whole of government thinking and alignment through initiatives such as Australia Public Service 200 – a grouping of the most senior executive staff which has been created to work together and identify programmes and projects to address key priorities.

To provide incentives for achieving cross-Government savings targets, gain-share arrangements are typically included within whole of government initiatives.

Budget Carry-over

Rules around budget carry-over vary on expenditure type:

- Departmental expenditure - can be rolled over one year to the next, subject to approval of the resulting impact on departmental accounts.
- Administered expenditure – there is no automatic/ legal right to carry-over of expenditure, however, the budget can be re-appropriated the following year based on merit and budget circumstances. Finance encourages early identification of carry forward amounts to enable better forecasting of the impact on the overall budget deficit/surplus in the next year.

Managing Interdependencies:

The inter-dependencies issue is dealt with in two ways:

- Department/ Minister proposing the policy is required to highlight to Cabinet the interaction with other policies and programs and the effects on other Departments; and
- The draft policy proposal is circulated around departments to provide opportunities for interdependency issues to be identified.

How budgeting links with strategy and performance

KPIs across all programme areas are reported to Parliament. This sets out performance for the current year and the KPIs for the coming year.

In addition, all new policy proposals are required to identify how their performance will be measured.

As stated above, performance information is used to inform the budgeting process rather than dictate the budget. Therefore whilst funding could be maintained against a particular priority area, low performance could indicate a reallocation from low to higher performing projects or providers.

On this basis, the predominant focus of performance information has been to improve the quality of service delivery and the allocation of resources within Departments rather than influence budget allocation at the macro-level.

Work is currently being undertaken to improve the range and quality of KPIs being monitored and to review the overall performance process. The aim is to improve performance information, move the process from being retrospective in nature to a more integrated approach with some more influence on budget decision making, and to one which considers performance on an ongoing basis and introduces more accountability.

As part of this improvement process the National Audit Office has been given a new role to audit KPIs and the quality of reporting against them.

Background

Directive central government approach

Incremental Budgeting Approach

Canada - summary findings

- ***Strategic and Operational Review of expenditure undertaken by each Department to identify savings of 5% and 10% over a 3 year period***
- ***Significant focus placed on performance assessment through the Program Alignment Architecture (PAA) and Management Accountability Framework (MAF)***

Macro-economic Context

Prior to the onset of the economic slowdown (in 2008 and 2009), the Canadian fiscal position was strong and operated budgeted surpluses year-on-year. The budget is currently in deficit but is forecast to balance in 2014/15. National debt in Canada is approx 35% of GDP.

Recent Spending Review Exercises

Two expenditure review processes have been undertaken.

Strategic Review – 2006 - 2010

In 2006 the Government enacted the 'strategic review' process. Undertaken over a 4 year cycle, the process considered approximately 25% of Departments each year and required them to:

- review all their direct expenditure programmes and assess performance against agreed objectives and criteria;
- identify 5% (soft target) of their direct expenditure (based on performance) for proposed savings/ efficiencies and propose options for re-investment.

This approach gave Ministers a menu of options against which budgets choices could be developed.

Years 1 – 3 of this review period was a prioritisation exercise and typically only 2.5% of the 5% savings identified were implemented. In year 4 the focus was on spending reduction (as the fiscal budget had moved into deficit and an economic stimulus plan was put in place).

Overall, the aim of the Strategic Review was to provide Ministers with options to reallocate funding based on objective performance measurement data and government priorities.

This Strategic Review process started when the fiscal position was in surplus and therefore was not driven by an expenditure reduction agenda but viewed as good budgetary discipline and management.

Strategic and Operating Review (or Deficit Reduction Action Plan) – 2011-14

Similar in approach to the previous Strategic Review but with a number of changes:

- Emphasis is now on reducing Government expenditure;
- Departments are required to propose options for 5% and 10% savings on operating and program expenditures over a 3 year period with at least a proportional share of savings to be from operating expenditure;
- Capital expenditure is excluded from departmental bases for the purpose of establishing targets but is eligible for savings proposals on an accrual basis, because including capital in earlier expenditure reduction exercises created unintended consequences (such as the deferral of capital maintenance which increased cost in the long term);
- No central 'invest to save' funding available.

"Firstly, at the macro-level, funding is allocated across programmes which align with Government objectives …

… secondly, comprehensive performance information on all programme expenditure is used to identify the areas which are best suited to achieving those objectives."

Macro-level budget setting process

The following approach is taken to setting budgets at the macro-level:

- Top-down – the overarching fiscal position is set at Cabinet level which cascades down to individual departments;
- Incremental approach – departmental budgets are identified year-on-year on an incremental basis (preference would be for more bottom-up zero-based budgeting but this very resource intensive).

How spending is prioritised

At the macro-level, funding allocations are aligned to Government priorities and objectives.

Individual Departments must then decide how best to achieve their objectives and allocate the budget they have been appropriated across their approved spending programmes, respecting cabinet and budget decisions on funding levels for these programmes.

Departments are expected to use performance based information on programme success to propose changes to funding allocations.

Other techniques used:

- Programme evaluations are mandatory every 5 years;
- Business cases and financial/ return on investment analyses are typically only used in commercial type projects.

Information used to support decision making

- Canada is recognised as having excellent information on programme performance (*See MAF and PAA references further below*)
- Costing information – currently held at departmental level, but improving understanding of costs at horizontal/ cross-departmental level could lead to further efficiencies. For example, it could provide greater clarity in terms of identifying duplication and understanding costs for internal services at a whole of government level – which would support development of business cases for improved efficiencies.

Enabling Cost Reduction

The following factors were identified as important in enabling cost reduction in Government.

Cross-departmental cooperation

Focus has tended to be on vertical efficiencies (i.e. efficiencies found within individual departments) rather than horizontally (i.e. Departments working together to find efficiencies). Two examples of how this is changing:

- Shared Services Canada – a single organisation created to provide back office services to Central Government;
- Departments are now permitted to sell internal services to each other.

Effective incentives

The following incentives have been put place to encourage good corporate behaviour:

- Management Accountability Framework (MAF) – an annual assessment of Departmental performance (explained further below);
- Year-end flexibility (called re-profiling – Departments can carry over 5% of Op Ex and 20% of Cap Ex from one year to the next;
- Deputy Heads (equivalent to UK Permanent Secretary) remuneration – a proportion of remuneration is considered 'at risk' and dependent on achievement of efficiency targets.

"...the (PAA) framework encourages departments to make positive choices on what is helping them achieve their priorities and to identify areas were savings can be made or were funding can be re-allocated..."

Flexing budgets between departments

This is distinct from year-end re-profiling. If one Department has a programme which achieves a Government objective more efficiently/ effectively than another, there is scope for funding to be re-allocated across programmes.

There are a number of factors to consider in these instances:

- It is essential that the funding is used for the purposes in which it was appropriated by Parliament (it must be used to help achieve the same objectives/ priorities);
- If transfers are made on a regular basis then the re-allocation would be made permanent;
- It is NOT used as a way to transfer funding from one Department which is unable to spend the money to another Department

Managing Interdependencies

This relates to situations where, decisions and actions taken in one department have a financial impact in another department. This is not a major issue in Canada but there is a process for dealing with it.

All Departments impacted by individual policy decisions have the right to convene a meeting at Cabinet level. Typically, a negotiation follows (at both the official and ministerial level) and an approach is agreed to address the budgetary impacts.

How budgeting links with strategy and performance

The Treasury Board Secretariat's *Policy on Management, Resources and Results Structures (MRRS)* supports the development of a common government-wide approach to the identification of programmes and to the capture and management of financial and non-financial information relative to those programmes.

This policy is implemented in a number of ways including the Program Alignment Architecture (PAA) and the Management Accountability Framework (MAF), described below.

Program Alignment Architecture (PAA)

The PAA is a common framework or template completed by all Government Departments which sets out the following:

- Strategic Outcomes of the respective Department;
- Aligns the Programs and Activities undertaken by each Department to the Strategic Outcomes; and
- Financial and non-financial performance information.

This is collated by the Treasury Board Secretariat (TBS) and allows for a strategic/ cross Departmental review.

Management Accountability Framework (MAF)

The MAF is a performance management tool used to support accountability of Deputy Heads and improve management practices across Departments.

All major Government Departments and a proportion of smaller agencies are assessed on an annual basis by the TBS across 14 'Areas of Management' (such as: people management, financial management and asset management.)

The organisations being assessed provide TBS with evidence relating to performance across each of the Areas of Management. On the basis of the information submitted, TBS then make their assessments. The results from the MAF assessments are used as an input in the Performance Management Program for Deputy Heads.

Background

Current budget deficit very low and moving towards balance

Enjoying strong economic growth

Regional Government (German "Länder") have much greater responsibilities than UK Local Authorities

Germany – Summary findings

- ***A 'Debt Brake Rule' requires the structural budget to be close to balanced***
- ***Recently moved from bottom up approach to top down***
- ***Budget flexing is encouraged in-year rather than between years***

Macro-economic context

In 2010 Germany introduced a constitutional 'Debt Brake Rule' which limits the federal structural deficit to 0.35% (i.e. 'near balance'). This path to 'near balance' was started in 2011 and is to be achieved in equal steps by 2016. The forecast structural deficit for 2013 is 0.54%.

The 'Debt Brake Rule' will also limit the structural deficit at the regional level (German "Länder") to 0% (to be achieved by 2020).

German federal government expenditure covers areas such as Social Affairs (including health), Transport Infrastructure, Development Aid and Defence. However, other major areas of expenditure such as police and education are mainly the responsibility of Regional Government.

Macro-budgeting process

The traditional cash based budgeting approach used in Germany was 'bottom-up', however with the introduction of the 'Debt Brake Rule' it was recognised that this would have to replaced by a 'top-down' approach.

However, this 'top-down' approach is applied differently to 'top-down' approaches applied elsewhere. In particular:

- The ability to use the significant knowledge and information already captured from the previous year's 'bottom-up' budgets provided a detailed insight to the Ministry of Finance ("MoF") – this insight is complemented by information gained from the budget execution process, in which MoF is involved intensively, e.g. the recognition of excess expenditure;

- With this insight, an analysis is then undertaken of the funding required to deliver objectives and this is used to define the appropriate funding envelope for each Ministry.

The process

The top-down process takes the following steps:

- Step 1: Identify legally required and binding expenditure in each Line Ministry. In Germany the bulk of federal expenditure is allocated on the need to fulfil binding/ contractual arrangements (social benefits such as unemployment cost and pension funding are determined by German Social Law). As a consequence the scope for discretionary expenditure is rather small;

- Step 2: In addition to step 1 the MoF invites the Line Ministries to submit information to support the budget development process, e.g. detailed statistics about current or expected expenditure relating to particular policies. No formal negotiations take place.

- Step 3: Expectations/ forecasts around taxation revenue and finances are identified;

- Step 4: On the basis of the information captured in Steps 1 to 3 above, the MoF propose a budget which is brought to Cabinet for approval, typically in the March of *“the ability to use the significant knowledge and information already captured from the previous year’s ‘bottom-up’ budgets provided a detailed insight to MoF in completing their top-down analysis.”*

the year before the budget year. The negotiation process only starts when the budget proposal is submitted to Cabinet stage, where agreement is sought at the political level. With this backing the budget proposal is relatively high level and could be called a ‘Cornerstone’ budget.

Step 5: Within the limits defined, each of the Ministries use this Cornerstone budget to develop their own more detailed budgets (this has a total of approximately 5,000 line items).

Flexing budgets

The rules for budget flexibility vary across expenditure types:

- Administrative expenditure (e.g. public employee staff costs and public building costs) – represents approximately 5% of total expenditure (but about 3,000 of the 5,000 line items) but there is great flexibility (100 % flexibility inside the main groups of flexible expenditure, 20 % in between main groups) and all under-spends can be carried over the next year;

- All other expenditure (i.e. 95% of total expenditure) –is guided by a rule that all investment expenditure can be carried over. Other expenditure in the budget plan can be eligible to be carried over. However, if funding is to be carried over from one year to the next it normally must be ‘covered’ (i.e. the additional funding carried over must be matched by an under-spend in another area). This is to ensure that debt limits are not breached.

  In practice this encourages flexing of expenditure in-year rather than between years.

  MoF can grant an exception to the requirement for expenditure to be ‘covered’ but this would only happen in exceptional circumstances. As a consequence, the MoF would have to compensate for the carry-over in another area of Government expenditure.

How spending is prioritised

Spending is prioritised as follows:

1. Legally binding expenditure must be met first

   Only if this expenditure can be financed are political priorities then considered (see below).

2. Priorities identified as politically already decided on (e.g. in the Coalition Agreement).

   The Coalition Agreement covers in detail proposals for each area of Government. Additional political decisions might be taken, and there may also be decisions in the coalition to deviate from the agreement

If these areas of expenditure are not affordable, then the Government has the option of changing the legislation (e.g. through a reduction in the payment of social benefits) or changing policy.

Analysis techniques used to identify efficiencies

Cost effectiveness and efficiency analysis approaches are used to prioritise capital investment projects. This is suitable for projects where the benefits are easily quantifiable.

The MoF can work with individual Ministries to develop savings proposals and in some cases they are responsible for driving reform processes and identifying areas for savings initiatives.

An example of this is the major structural reform in defence. Reform measures included a change from conscription to a professional army, location of army bases and provisions for equipment.

"Cost effectiveness and efficiency analysis approaches are used to prioritise capital investment projects"

Barriers to cost reduction

The following barriers to cost reduction were identified:

- Institutional barriers – e.g. there is historic/ legacy opposition to new approaches to service delivery, such as the introduction of Public Private Partnerships (PPP).
- The Departmental Principle – In Germany, each Line Minister has a strong Constitutional position. As the Federal Chancellor sets the general guidelines of policy, each Line Minister conducts the affairs of his department independently and on his own responsibility. This implies adequate financial means.

How performance informs the budgeting process

The performance of individual Ministries is reviewed by the Federal Audit Office who issue three types of report:

- Reports to Line Ministries – these reports are issued to the individual Line Ministry for comment and then circulated to the MoF. These reports make recommendations for changes;
- Annual Audit Office report – in addition to general comments on Government standards and practices this report lists the most serious performance issues across the Federal Government.
- Report to the Budget Committee – in serious cases, the Audit Office can also report issues about a Line Ministry to the Parliamentary Budget Committee. A subcommittee of the Budget Committee does also discuss every single case that is reported on in the Annual Audit Office report. This Committee can take decisions that require a Line Ministry to take action to address issues that have been identified.

Although performance is not directly linked to the Federal level budgeting process, critical Audit Office reports issued to the Budget Committee can indirectly impact budget allocations.

There is a lot of reporting within the government, executed by the line ministries. More or less each area of policy is covered by one or more reports, many of them periodically. Despite not being integrated systematically to the budgeting process, MoF use these reports, which normally provide a range of performance information, for its budget preparation.

Background

C90, 000 employees

Various interdependent businesses

Incremental Budgeting Approach

Cross Line of Business approach

Capex approached separately

Continuous approach to re allocating funding

Large UK plc - Summary findings

- ***Subject to significant regulatory scrutiny***
- ***Moving to a more targeted approach to budgetary effort and focus.***
- ***Aligning plans across the business remains a key challenge***

Background

The company operates a portfolio of interrelated Lines of Businesses (or divisions) within an overall Group structure. It is subject to regulatory oversight and has long term efficiency savings targets.

Historically the company has been strong in projecting its revenue and expenditure at a high level.

The budgetary process has evolved over recent years and is the subject of continuous improvement effort.

The budget process

The budget process differs across the three types of expenditure:

1. Resource Budgeting
2. Transformation Budgeting
3. Capital Budgeting

These are discussed in turn.

1. Resource Budgeting

The standard resource budgeting process within the company is based on a combination of methods, but is primarily incremental. The primary drivers for the budget are created at group level and these are prioritised on 4 high level metrics:

- Top Line Revenue;
- Profits (EBITDA); and
- Net Cash Flow;
- Total Employment.

The budgeting process is owned by the Finance function both at Group level and within each Line of Business. A Central Finance team (operating at a Group level) then consolidate the budgets received from each Line of Business.

Top-down

This Central Finance team prepares a series of budgetary scenarios based on optimal and stretch targets for each of the Lines of Business.

Bottom-up

At the same time, the Lines of Business each prepare a bottom up budget typically using a combination of incremental and trending techniques. These trends are developed and analysed using wider economic data.

Top-down v Bottom-up

There is a process where the Group view (i.e. top-down) and Line of Business views (i.e. bottom-up) are aligned through 'discussion sessions' and from that detailed sets of budgetary targets are agreed.

These targets are cascaded through the Lines of Business and take the form of specific KPIs and metrics.

Non-financial inputs

The non-financial inputs typically relate to product sales and headcount and are essentially about resource planning and matching supply with demand. For example, one division plans and budgets for the activities of over 20,000 engineers. Furthermore, there are multiple resourcing models within the company and aligning them is a major challenge.

“The key metrics are top line revenues, Profit (EBITDA), Net Cash Flow and headcount.”

This end to end planning cycle takes 4 – 4.5 months to complete.

2. *Transformation Budgeting*

Transformation projects are managed either within each Line of Business or at the Group level. These projects are all managed ultimately by the Head of Transformation who reports directly to the CFO.

Transformation projects can be growth-related (e.g. new product launches) or cost reduction projects (e.g. organisation restructuring). The Head of Transformation has overall financial targets to achieve and decides the best delivery and governance model for each project.

These projects can be managed at an individual Line of Business level, cross-Line of Business level or Group level.

3. *Capital Budgeting*

There are typically more than 100 capital projects underway within the company at any one time. Capital spend can be either cost transformational, revenue generating, or infrastructure related.

Each year, the CFO commits a % of revenue to capital spend and this is usually communicated in external guidance. The capital budget is then allocated in the first instance to projects already committed and ‘in flight’ from previous years and the remainder is allocated to new projects.

All Capital projects are prioritised (and delivered) with oversight from the Capital Board. The Capital Board is made up of main Board members, the CFO, Capital Managers and other representation from operational teams.

The budget cycle is reviewed between 2 and 4 times per year.

Governance around the Budget Development Process

The Governance arrangements are as follows:

- The Resource budgets are developed by each Line of Business and overseen by group finance. The CFO is ultimately responsible for the entire process;
- Transformation Budgets are overseen by the CFO and the Head of Transformation, who manages all activities, which cascade throughout the business;
- Capex budgets are overseen by the Capital Board who manage ‘in flight’ programme expenditure and rationalise new capital investment requirements.

Budgets are communicated widely internally within each Line of Business. Very high level guidance is communicated externally (in particular to the Financial Markets) via the Investor Relations department.

Linking Budget Planning and Operational Planning

These linkages are made within each Line of Business where finance interface with operational management. The resource budgeting within the company is driven by operation volumes such as new customers by product, attrition rates etc.

On-going budget monitoring

There are monthly reports produced on progress against budget with detailed explanation of all material variances.

The company indicated that historically they have been very strong in managing budgetary accuracy at an aggregate level across the group.

“Capital projects are considered in terms of NPV, strategic importance and regulatory requirement.”

Flexing budgets in-year

There is no specific timetable for adjusting budgets in year. Through the monthly review process (and more regularly if required) there is an escalation process that brings any significant changes to the attention of senior management.

This process is owned by the Group Central Finance team and it is initiated where there is a change to market circumstances (e.g. a major competitor campaign). This is known as the **Budget Adjustment Process** and is a rigorous challenging process which results in an approval request for budget adjustment.

How spending is prioritised

Operating Costs

When high level targets are translated into detailed plans, the ongoing staff and overhead budget is adjusted accordingly i.e. spend is determined by the desired shape of the business. A set of complex metrics are then used to determine spend in each area e.g. number of engineers, IT support projects and working capital projections.

Transformational Projects

A total spend budget for transformation projects is agreed annually and prioritised on a variety of factors such as new market opportunities, benchmarking data, cost reduction opportunity, business service levels and regulatory demands.

Capital Projects

Candidate capital projects are analysed over a number of criteria, typically:

- Net Present Value;
- Strategic importance; and
- Regulatory/ external requirement.

All Capital projects are prioritised (and delivered) on the basis of the criteria above, with central control and oversight from the Capital Board.

Analysis Techniques

The following analysis techniques are applied:

- Financial – NPV, Payback and Return on Investment analysis typically undertaken as part of a capital project and transformation project appraisal;
- Top Line growth and EBITDA (Earnings before interest, taxation depreciation and amortisation) are the key financial drivers for all prioritisation of non capital spend
- Total labour cost is a key driver for budgetary control and transformation focus including spend to save.
- Non-Financial – there is a complex range of non financial metric specific to each Line of Business.
- Regulatory mandated spend is typically non-negotiable.

Improving the accuracy of forecasts

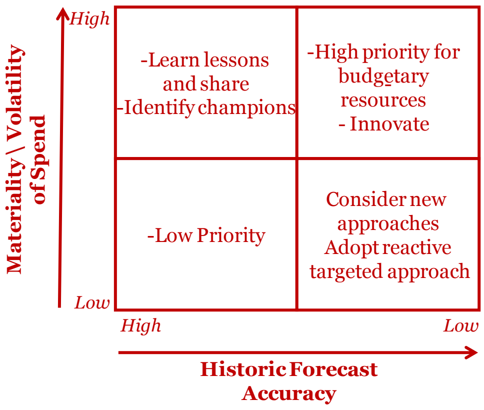
There are no metrics that monitor the end to end effectiveness of the budgetary process within the company however it is recognised as an area for improvement.

To this end the company has recently started to develop a ***budget effort prioritisation matrix*** process, the intent of which will be to analyse the budget across two dimensions:

- **Volatility** – how volatile is the revenue or expenditure line? E.g. revenues from an existing product may be relatively stable, whereas new products are highly volatile and dependent on the success of marketing campaigns;
- **Historic Accuracy** – how effective have management been in forecasting revenue/ expenditure areas in the past?

"Budget effort is prioritised in the areas which have historically been volatile and forecast accuracy is low."

Budget Effort Prioritisation Matrix



This matrix recognises that large organisations have the potential to learn internally from the range of practices they undertake.

Even budget lines which would fall within the 'High Priority' box are also considered in terms of their materiality, to focus further efforts on the major areas of expenditure which are difficult to forecast.

Linking Budgetary performance to budget holders Personal Assessments

The company historically cascaded budget effectiveness (as determined by accuracy of forecasts) into budget-holders personal scorecards. However, this has been discontinued as it encouraged bad behaviours (e.g. hidden contingencies and increased discretionary expenditure towards the end of the year).

Going forward each Line of Business will have a performance scorecard that will monitor compliance with the budgetary process at a very high level (e.g. budgets submitted on time, all information supplied etc.)

Budget holders personal scorecards will then be linked to the overall performance metrics of the business unit.

How budgeting links with strategy and performance

Strategic Planning

A five year corporate plan sets out the strategic objectives identified by the Board. This is cascaded down through each Line of Business and links to the budgeting cycle through the production of a detailed rolling 12 month budget and a higher level 3 year budget.

The budgeting cycle also includes a forecast for the current year end.

Background

Natural Resources Company

20,000 employees across 36 countries

No set budget – business driven opposed to calendar driven

"They wanted to take reality seriously – not just a dynamic and unpredictable business environment but also all its great people."

Natural Resources Company - summary findings

- ***Budget purposes separated – target setting, forecasting and resource allocation***
- ***Move from calendar to event based performance management***
- ***Self regulatory process – focus on principles not rules***
- ***KPIs are just an indicator – holistic approach on performance is taken***

The budget process

The company does not have a traditional budgeting process because it concluded that traditional budgeting was no longer as relevant in the modern age. It was insufficiently dynamic and not a good fit for the modern employee.

In 2005, they moved away from traditional budgeting where the same set of figures represents targets, forecasts and resource allocations and these figures are set prior to the financial year. In 2010, they took a further step, as they reduced the annual nature of budgeting and moved toward a more continuous process.

Their model is inspired by 'Beyond Budgeting'. They wanted to take reality seriously – not just a dynamic and unpredictable business environment but also all its great people. Their thinking is set out in the diagram below.

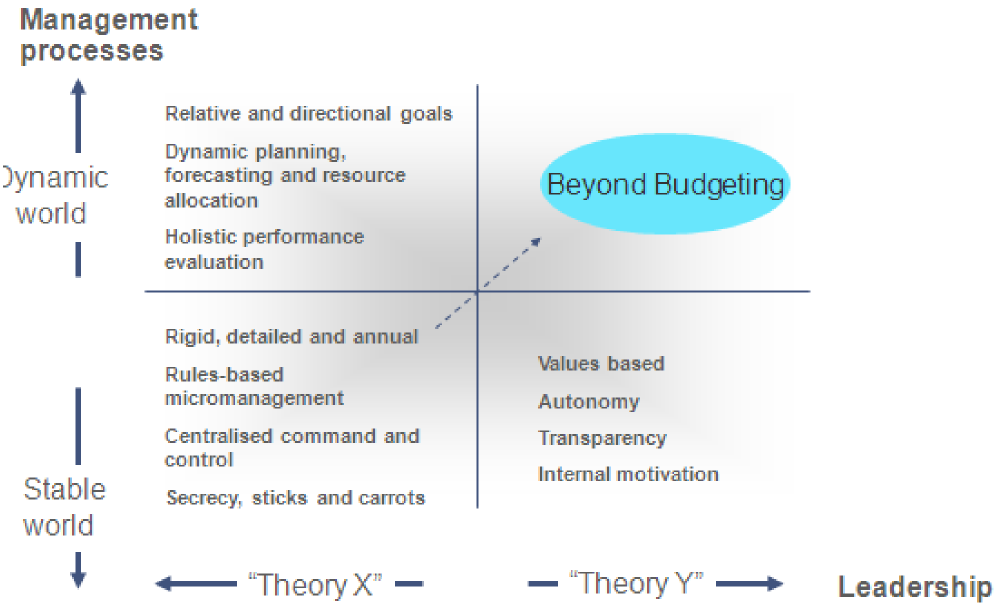


Figure 1 Moving to a new budgeting approach

Their rationale is that while traditional budgeting processes served well in a stable world, as the world has become less stable and more dynamic and views on leadership have evolved, a whole new approach to traditional management is required, including budgeting.

What did they want to achieve?

The aim was better performance by setting better targets, getting better forecasts and allocating resources more efficiently.

To achieve this, they operate with separate figures (with varying frequency and time horizons depending on need) for targets, forecasts and resource allocation.

This distinguishes between what they want to happen (i.e. targets) from what they think will happen (i.e. forecasts). Getting unbiased information on forecasts was important to senior management, whether it was good news or bad news, because it meant they could react or plan accordingly.

This system, summarised at a high level in *figure 2,* minimises the amount of 'gaming' in the system and is aimed at reducing arbitrary resource allocation based on previous years. It also means there is no challenge of re-allocate resources mid-year (as they have not been pre-allocated in the first place). "*The bank might be open twelve months a year, but you can still get a "no" on your project funding request*."

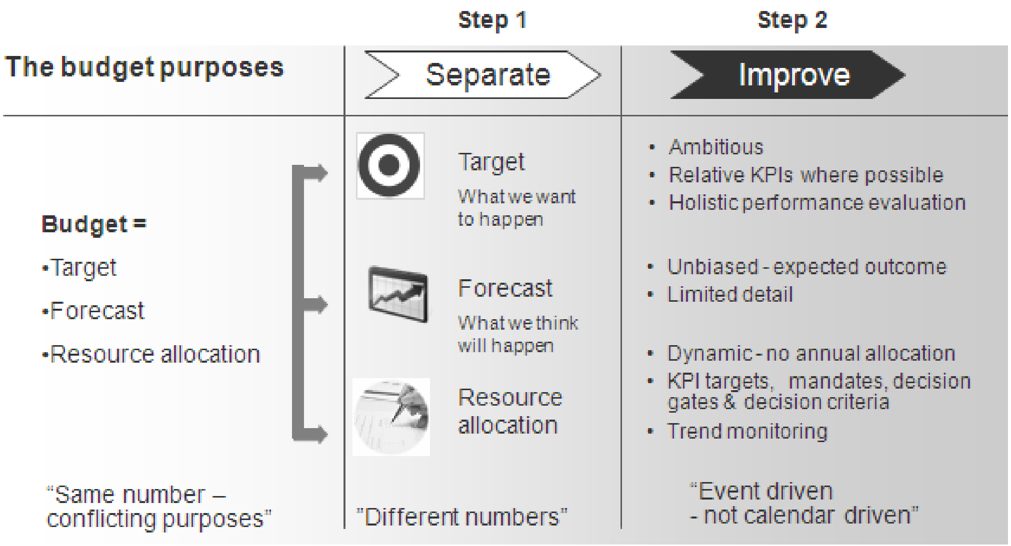


Figure 2 Separation of targets, forecasts and resource allocation

"a knowledge organisation – with mature and responsible people. We don't need to micro manage costs.

It is about trusting individuals, to do the right think for the company. We want the system to be self regulating."

What was the driver for this change?

The company consider themselves as *'a knowledge organisation – with mature and responsible people'*. It was not appropriate for a central department to dictate resource allocation based on imperfect/limited information. A central department is unable determine the optimal total resource allocation between areas. Furthermore it is especially challenging to make these decisions three months prior to the start of the financial year.

As one example, the company does not have a travel budget. They feel that they could not come up with an optimal level of travel spending and that it was not their role to micro manage staff over their travel decisions and expenses.

The aim is to trust individuals to do the right thing for the company and to enable intelligent conversations to focus on what the company wants to achieve. This does not exclude a firm intervention in those cases where trust is abused.

Governance Arrangements

Facilitation, guidance and challenge is provided by the central performance management team. But each team sets their own targets and measures based on a balanced scorecard approach called 'Ambition to action'.

The key is to have a principle driven management process that is self regulatory in nature.

How spending is prioritised

Prioritisation is evaluated on value creation, risk and strategic fit. Where management believe they have an advantage is that decisions are taken with more information and at a date closer to project commencement.

As resources are allocated on an event basis (rather than a calendar basis), there is less emphasis on prioritisation techniques. However in terms of capital expenditure and operating expenditure decisions, the following tools are used:

Capital expenditure

A capital value process is used as a decision making tool. Projects are matured through decision gates and receive a green (or red) light and funding at Decision Gate 3. In this way, decisions are made when the freshest and best possible information is available, in terms of project quality and capacity to resource (from both a financing and people perspective). The capital budget is continuous with no annual budget set.

Operating expenditure

In relation to operating expenditure decisions and cost control there is a variety of approaches adopted, including:

- Unit cost targets –these are a self regulating tool e.g. more production spend is allowed if more is produced;
- Cost frame/burn rate guidance – this is not a pre-allocation of funds, but an overall cost guidance without any of the details of a traditional budget. It is valid until something else is decided;
- Tough bottom line target - this is an indirect way of managing costs; one can spend more if the cost incurred creates value.

How budgeting links with strategy and performance

The company has devoted a considerable amount of effort into linking strategy and performance management.

The main tool used is their 'Ambition to Action' approach. It is a balanced scorecard approach combined with Beyond Budgeting (see BBRT.org) which aims to take the strategy and implement it into actions.

Principles of performance management system

The key principles of 'Ambition to Action' are:

- To perform better than those we compare ourselves with.
- Do the right thing in the actual situation your Ambition to Action, decision criteria and authorities and sound business judgement.
- Within this framework, resources are made available or allocated case-by-case.
- Business follow up is forward looking and action oriented.
- Performance evaluation is a holistic assessment of delivery and behaviour.

The purpose and process

"Ambition to action is a balanced scorecard approach, which focuses less on KPIs being achieved and is more holistic."

'Ambition to Action' gives teams flexibility, ownership and control over the process.

The process follows a similar pattern on each level of the organisation:

- Strategic objectives – Where are we going and what does success look like?
- KPIs – How do we measure progress?
- Actions and forecasts - How do we get there?
- Individual and team goals – What is my or our contribution?

Where the company differs is that they see KPIs as indicative only. They are keen to stress the KPIs are just a measurement, not an action and they take a more holistic view of performance. For example, their main financial KPIs are 'relative Return on Average Capital Employed ("RoACE") and relative Shareholder Return. There is no percentage target for RoACE but to be in the top 25% relative to other selected companies. This puts the focus on relative rather than absolute performance which can be misleading. For example your target was 10% but you achieved 15%, so you meet the target. But the industry average was 20%.

How is the strategy implemented across the team?

In total, the company has 1,200 'Ambition to action' plans in place, meaning most teams have one. Each one is unique and is set by the team. But there is a need for sufficient alignment across different teams. Traditionally this was done by cascading (i.e. top down) but ownership and quality can be lost. Managers own it but it is based on ambition levels and direction of other relevant Ambition to Actions, typically the one above but it could also be neighbouring units.

performance is strong, not solely because of our budget process....but we think it has been a factor."

How are performance reviews undertaken?

All employees are evaluated by the same framework. Business delivery goals (defined by or inspired by Ambition to Action) and behaviour goals (defined by company values and people and leadership principles) both have equal weighting. Development plans and remuneration is linked to this definition of performance, which mainly impacts the base pay, but for some employees can also impact the variable element. The aim is to facilitate performance management, not to manage it.

How is the company seeking to improve the system?

They want to build on the work they have started, including trying to escape the calendar year wherever possible and relevant.

- No annual requirement – full freedom to update Ambition to Action when necessary;
- Seek approval if big updates, inform if small;
- Varying time horizon on targets and forecasts, as appropriate for the team;
- People development could be the next stage for the company. They are considering a move away from annual reviews to more natural review points.

Background

Supplier of water and sewage treatment

C5, 000 employees

Zero-based Budgeting Approach

Significant ongoing capital budget in region of £1bn per annum

"It's slightly more than a budget…. we take a long term view as well as a short term view."

Large UK Utility- summary findings

- ***Regulatory requirements are a significant factor in its business and consequently also on budgetary processes.***
- ***Significantly benefited from move to more structured budgetary process over last two years.***
- ***Focus not just on annual budget but also on rolling five year Business plan with regularly updated forecasts.***
- ***Detailed cash budgeting a central control for the company's operations***

Background

The Company's principal activities are the supply of water and the collection and treatment of sewage to a customer base of over 10 million users which is growing slowly in line with local demographics.

It operates in a highly regulated environment which has a significant influence on its budget-setting process.

There is a substantial and ongoing programme of capital expenditure.

The budget process

They describe their process as more than a budget. It includes a forecast and a medium term plan in the form of a five year forecast which aligns to the regulatory cycle. This is split by year. They have also completed their first view of the next regulatory cycle, ending 2020. They need to take a long term view as well as a short term view. The process has four key elements:

- Forecast
- Annual P&L, cashflow and capital budgets
- Internal Business Plan (IBP)
- 5 year forecast

These are discussed in turn.

Forecast

The finance team produces a forecast every month. For the budget process a more "deep dive" current year forecast is completed which then provides a basis and comparison for the budget.

Budget

The annual budget process is largely a bottom up process. It starts off in the business units which are asked to provide cost centre budgets that will account for each penny they plan to spend. This is captured in their accounting system, SAP, and then consolidated using Hyperion.

The approach used to budgeting is essentially zero-based, but although they are built from the bottom up, there is also an element of "top-down" in the process. The business plan, the previous year's 5 year forecast and the Final Determination (FD), the regulatory plan agreed with the regulator, all provide top down targets for the business. This provides the business units with a guide to what they need to achieve.

The budget is split by cost and revenue type, capex, cashflow and headcount. It also is split by month. The budget is set to deliver operational, serviceability, customer service and output targets that the company sets its self. These are set with reference to the FD.

"The budget gets compared back to the original business plan we set ourselves. We are constantly challenging ourselves"

The cashflow budget is also a bottom up exercise using a direct method of cashflow, budgeting for each major item of spend and revenue by month.

Internal Business Plan (IBP)

At the start of the current regulatory period the Company set an IBP. This covers all financial aspects of the business and is fixed and approved by the Board and Shareholders. It provides the direction for the business for the next 5 year period.

5 Year Forecast

As part of the budget process a 5 year forecast is also produced. This is split by year and is compared to the IBP; the previous year's 5 year forecast; and the regulatory elements are compared to the FD.

These forecasts are entered into the Company's financial models and can be flexed to assess the long term value of the Company, compliance with covenant ratios, debt requirements and returns to shareholders.

Capital Expenditure Budgeting

Capital budgeting is linked to all three stages of the budget process identified above. At a high level it is driven off the 5 year rolling plan. It is a highly significant element of each year's budget with capex expenditure at approximately £1bn per annum.

All Capital projects require approval by the company's capital committee. Because the company's business is regulated many of the projects must comply with regulatory requirements. However they are still required to go through the same approval process. Each project submission has a standard template produced which includes an NPV analysis.

Governance around the Budget Development Process

There is a formal process of preparation, review and approval. The process has the following stages:

- The budget is prepared at business unit level;
- It goes through a review process where each business unit has to present their budget to the CEO & CFO;
- Following review the budgets are then submitted for approval by the board.

High level budget figures, once approved, are communicated widely internally across the company with updates on performance against budget each month. Each Business Unit then takes responsibility for monitoring progress against their budget.

Linking Budget Planning and Operational Planning

There is a direct link between budget planning and operational performance. As noted the budgets are primarily prepared on a bottom up basis by each operational business unit and there is a direct link to the financing requirements.

On-going budget monitoring

Monthly performance reports are produced to compare performance against the budgets and forecasts.

These enable the company to monitor performance both at a corporate and business unit level and to consider actions that may be put in place to reduce costs or improve efficiencies.

Flexing budgets in-year

Due to the regular updating of forecasts, budgets are not flexed or adjusted in the course of a year. Once a budget is set it remains unchanged.

“The company’s key focus is very much linked to its medium term planning process rather than taking a purely short term perspective.”

Benefits of budgeting approach

The Company has only adopted its current approach to budgeting in the last two years, with the following changes now in place:

- they can now compare their outturn performance against their FD;
- they have a 5 year forward looking business plan;
- they produce an IBP;
- forecasts are now updated monthly.

They have identified significant benefits from their new approach such as:

- Increased understanding of the business;
- The ability to anticipate problems not just this year but for the next two years; and
- More closely monitor the benefits of measures being undertaken.

How spending is prioritised

Operating Costs

Operating cost budgets are developed on the basis of delivering operational performance, serviceability and customer service.

Capital Projects

Capital projects are similarly regulated. Prioritisation decisions will first be taken on expenditure items that meet the company’s regulatory requirements. Non-regulated expenditure decisions are then taken based on a number of criteria and typically would include:

- Net Present Value;
- Strategic importance; and
- Risk associated with project.

All Capital projects are prioritised (and delivered) on the basis of the criteria above under the control and oversight of the Capital Committee.

How budgeting links with strategy and performance

Strategic Planning

As the company operates largely on a rolling five year business planning cycle, considerable strategic planning is required. Although the current cycle is not yet half way through, management have already started their planning for the next five year cycle, effectively developing an eight year outlook.

Performance

The company uses a range of KPIs to help it monitor its performance. Many of these will be at a business unit level and non-financial in nature (e.g. relating to customer service, flooding incidents and leakage reported).

The Key Financial KPIs are:

- Operating Expenditure;
- Capital Expenditure;
- EBITDA; and
- Cash Flow before Funding

Background

Global Provider of Integrated Power Systems

£11 bn. Turnover

C40, 000 employees

Zero Based Budgeting Approach

"The major features of the planning system are: a) forecasting the activity of the customer (when they will operate the equipment; b) forecasting the reliability of the parts; c) when the customer will require an overhaul shop visit; and d) which parts will require replacement and at what cost."

Multinational engineering group - summary findings

- ***Many products in service for up to 25 years so need for long term planning horizon.***
- ***Need to anticipate customer activity and when there will be a need to perform regular maintenance and overhaul of products***
- ***Short time frame for budget production so that data to prepare budgets is fresh and up to date***

Background

The group is a major listed company. It has four principal business segments and operates globally with manufacturing facilities in North America, Asia, UK and mainland Europe.

It designs and develops high-technology products which are often in service for up to 25 years. The company frequently contracts to maintain and overhaul the product over its lifetime as part of the original equipment contract i.e. enters into a life-time maintenance contract.

The major features of the planning system are therefore:

a) forecasting the activity of the customer - when will they operate the equipment;
b) forecasting the reliability of the parts;
c) when will the customer require an overhaul shop visit; and
d) which parts will require replacement and at what cost.

The budgetary process is well established but continues to evolve and is the subject of continual improvement.

The budget process

The process is consistent across all main business segments and is linked in with the company's long term plan objectives.

The essence of the budgetary process for a year begins at the end of September in the previous year when overriding economic and cost assumptions and planning targets are issued from the central finance group.

Draft budgets in the form of 15 month forecasts, which get entered into Hyperion, are filed by the end of October. During November, a series of budget reviews are performed to a 'weekly drum-beat':

- Week 1 – each segment's draft budget is reviewed by the Group Financial Controller.
- Week 2 – each segment budget is reviewed by the executive board;
- Week 3 – any re-submissions as determined from the reviews are made; and
- Week 4 – the budget is issued to the main group board for approval which should take place at the board meeting in the first week on December.

There is one minor tweak to the budget in January to align opening balances with actual start of year balances.

Along with the budget, the group also produces a 10 year plan. This is updated in May each year, and gives an overall context for the budget.

The 10 year plan helps in the formulation of targets that form part of the background for the budgets.

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Targets are set in four key areas:

- Profit;
- Cash conversion (that is the proportion of profit that is converted into cash during the year);
- Capital Expenditure targets; and
- Working capital targets in terms of ratios such as stock turn, debtor days, creditor days etc.

The targets to be used for budget setting are debated in September of each year. They are approved by the executive board.

Budget outputs

The outputs from the budget process will include:

- A summary calendarised income statement;
- Projected calendarised balance sheets;
- Projected calendarised cash flow statements;
- Manpower budgets;
- Capital Expenditure budgets; and
- Departmental resource and operating cost budgets.

A consolidated version of these outputs is produced for the board submission.

The group has over 200 legal entities and budgets are produced for each of these. However, apart from the basic building blocks of the financials, the level of detail required for each sector is not laid down in detail. However, there must be enough detail by geography provided to enable the corporate centre to undertake tax, treasury, and FX planning for example.

Budget Flexing

Regular updated forecasts are produced in the course of the year, which take account of events that were not anticipated at the start of the year.

Governance around the Budget Development Process

The Governance arrangements are as summarised above with a series of review processes in November each year culminating in Board approval at the start of December.

Externally, budget guidance is given to the City (i.e. the Financial Markets) covering turnover, profit and cash flow alongside the preliminary results, at the half-year and at the Interim Management Statements (IMS) dates. Internally a summary of the budget is circulated at a high level. Each Business sector is responsible for disseminating, as it considers appropriate, and managing its own budget.

Dealing with inter-entity business

There is a strong management process around linkages between each Business Sector. The group operates in supply-chain units ("SCU") and customer facing business units ("CFBU"). The budget process starts with the CFBUs' sales plans which are converted by the SCUs into a load for internal factories and external suppliers.

There is also a process for internal charging of shared-service costs e.g. IT and Facilities Management. These charges are determined annually and charged to each business unit on a monthly basis.

On consolidating the budgets there are checks performed to ensure that inter-business unit transactions are broadly balanced.

"One of the things we're keen to get away from is 'just because it's in the budget I can spend it'"

On-going budget monitoring

Regular monitoring of performance against budget is undertaken. The monthly outcomes are examined in detail by each business segment to explain variances in actual performance from the budget.

On a quarterly basis the forecasts are updated to take account of any trends in variances between the budget and actual figures that are identified.

How spending is prioritised

The group has a straightforward methodology for prioritisation of expenditure, covering both operating and capital items. The issues that are considered in allocating resources include the following criteria:

- Meet a mandatory or regulatory requirement;
- To comply with or retire a Health & Safety issue;
- Meet a customer commitment; and
- Improving business performance e.g. enhancing technology.

Distinguishing BAU and Special Projects

Virtually all spend goes through underlying profit. Spend to save initiatives or restructuring costs are all taken as business improvement costs and are charged as a cost against underlying profit. They will still be subject to separate business plans that will need to demonstrate that savings will result from the initiative. An NPV for the value proposition will be computed.

Decisions around whether to proceed with a project have several phases before they materialise. When a project is proposed it is subject to an 'initial look', which, depending on its size, could involve the Group Financial Controller, the Financial Director and the Chief Operating Officer. If the 'initial look' is regarded as having merit, a more formal evaluation, including the normal NPV analysis, assessment of risks and mitigations will be prepared for approval.

These opportunities can arise and be considered at any time as they are all treated as "Business as Usual" expenditure.

Approval of Expenditure

There are formal approval procedures for expenditure. Above a certain level [this is confidential] a project will require board approval. Otherwise it can be sanctioned at sector level.

In prioritising expenditure the company uses normal financial type measures such as net present value and internal rate of return, but beyond that there are a number of other factors that will be considered such as health and safety issues, mandatory expenditure or production capacity considerations. Different weighting can be put on these depending on the circumstances.

Varying Budgets

As noted above, business opportunities are considered as and when they arise. People are not constrained by budgets and if a decision involves a switch of spending between one area and another or between one accounting period and another, this can be easily facilitated if there is a good business case to justify the decision.

How budgeting links with strategy and performance

Strategic Planning

The group, as already noted manufactures some products that are expected to have a 20 – 25 year life span, which will require maintenance either on a pay-as you go basis or via a formal maintenance agreement. Consequently there is a real need for long term planning by the group.

“We’re not wedded to a ‘budget gets bonus’ culture…. we’re grown up enough to realise that things change”

A major element is the group 10 year plan which is fully updated in May each year.

The group strategy is to be in four global markets and to invest in technology, infrastructure and capability, to develop a competitive portfolio of products and services and to provide through-life services. Each business sector produces its own 10 year forecast. This is financially consolidated each year, and if it does not align with the strategic objectives above and deliver enhanced, competitive returns it is revisited and revised in order to endeavour to meet those objectives.

The budgeting cycle each year takes account of the 10 year plan and the targets for the budget are based on the latest edition of the plan improved as considered feasible at the time of budget preparation.

There should be a link between the budget and the strategic plan. But it’s not as strong as it could be. “We are good at doing forecasts, but we need to be better at planning and re-planning on the back of the forecasts. We are also working to improve the linkage between the budget and the longer-term strategy.”

Performance

There is a performance bonus system in place, which is mainly based on corporate profit and cash targets. It is primarily driven off corporate objectives of year on year improvement and will reference market expectations along with how the budget adds up. Group performance creates the bonus pool, part of which can be re-allocated between sectors at the discretion of the executive.

The company measures sectors against how they did in the circumstances that existed during the year, not necessarily against the way they viewed them when they did their budget. It’s about taking out unknown factors and being fair with people, viewing how they did against the circumstances they experienced rather than the budget they prepared.

However budgets prepared do need to have fidelity and be achievable whilst reflecting a degree of year on year improvement. If unrealistic budgets are submitted people can be misleading to the centre and potentially also misleading to the City. As noted above, the Budget does not necessarily relate directly to the performance bonus, so there is no “Budget gets Bonus” culture, which helps with behaviours.

Nevertheless, there is a good budget culture in the organisation. In asking the question, “How important is a budget?”, the response is “employees respond really well to having a budget they do not exceed, but we’re grown up enough to realise that things change”. Communication is the key, if the budget does not quite meet the corporate objectives, then everyone knows that they must contribute to closing the gap.

Background

Metropolitan Local Authority

Incremental Budgeting approach adopted

Undertaking a significant Transformation of services exercise at present as part of the ABC Programme

Coventry Council – summary findings

- ***£146 million of savings to be achieved over a four year period from 2011 – 14***
- ***Transformation Reviews have been undertaken in support service areas initially but are being undertaken in some service delivery areas (e.g. Children's Services Review)***
- ***Experience and understanding of cost drivers in the organisation is critical to identifying areas for efficiency***

Background

The Council is currently in the midst of a significant cost reduction phase. The Government's Comprehensive Spending Review in 2010 requires the Council to make savings of £146 million over the period 2011-14.

In support of the cost reduction measures, the Council is also implementing a significant organisational change programme, called the **ABC Programme**. The largest initial reforms considered have tended to be back office services (Finance, HR and IT), but other front line services have been considered and there is currently a major review ongoing into Children's' Services.

The budget development process

The budget development process is a partnership arrangement between the Corporate Management Board (comprising senior Council officials including the Chief Executive) and the Finance function.

The Finance function develops a pre-budget report which sets out a range of proposals which are presented to Cabinet.

The process of developing this Cabinet Report is a consultative one and in addition to regular briefings with Corporate Management Board and Council Cabinet members, the following groups are consulted:

- Voluntary Sector;
- Businesses;
- Trade Unions;
- Residents.

The consultation is ongoing throughout budget development/ inception through to implementation.

Revenue expenditure

Incremental approach is used for annual budgets. Information from completed transformation reviews also informs specific service area budgets.

There is often revenue funding supporting capital grants and this also informs revenue budgets.

Capital expenditure

The following approaches are used collectively to identify the capital budget:

- Incremental approach used for ongoing work programmes such as maintenance;
- Type of resource flow – a large (but diminishing) proportion of capital expenditure is funded by Central Government grants (typically DfT and DfE). The level of grant funding therefore influences the capital budget.

Governance Arrangements

The overall direction and guidance for the budget comes from the Council Cabinet.

In addition, the Council Management Board considers budget matters approximately 8 times per annum and is responsible for providing a robust challenge to budget proposals developed.

"Benchmarking cost against peer groups can be very effective in identifying efficiency opportunities.

The Council used this approach on its IT function and identified efficiencies of 30% have been achieved."

Full Council are ultimately responsible for approving the budget.

Resources for Budgeting

There is a centralised Finance function within the Council, and staff within the function undertake a range of financial tasks rather than being dedicated to single activities such as budgeting. There are a number of reasons for this:

- The workflow over the year is not static;
- The overall numbers of finance staff would make segregation difficult;
- Senior managers across the organisation prefer a single point of contact within Finance for addressing issues/ queries; and
- Offers finance staff a range of experience and reduces 'key person' dependency risk.

Central government planning impact at Local Authority level

The Council indicated a desire to see greater certainty from Central Government in terms of levels of grant funding awarded.

This includes ending the huge uncertainty surrounding the business rates retention scheme, reducing the continued use of one-off specific grants, and establishing greater clarity with regard to the interaction between the local government and health sectors.

How spending is prioritised

Given the budget development process is incrementally based, the approach often taken is to 'de-prioritise' expenditure.

Step 1: Find efficiencies

The first step is to identify efficiencies which are identified through undertaking Transformation Reviews across a range of service areas. Individual service areas are subject to an initial diagnostic to consider if there is potential for significant savings, and if so a full review is undertaken. Other approaches to identifying areas for review are:

- Empirical evidence – for example benchmarking cost against peer groups. The Council used this approach on its IT Function and identified efficiency savings of 30% have been achieved;
- Ideas from other authorities – the Finance Director is a member of the Society of Municipal Treasurers and there is significant discussion and sharing of ideas across this group in terms of how efficiencies could be identified;
- Experience and organisational knowledge – the Finance function and some service managers have a good understanding of cost drivers in the organisation and therefore have a reasonable understanding of where scope for efficiencies may exist. Things to consider include old working practices and significant tie-up of assets.

Step 2: Follow Council Manifesto priorities

The lead party's manifesto identifies the expenditure priorities, which the budget should seek to address.

Typically therefore, in an environment where expenditure reductions have to be implemented, the higher priority areas tend to have their budget allocations protected relative to lower priority areas.

Analysis techniques used

Analysis of service areas tends to focus on two areas:

- Financial analysis – in particular efficiency analyses from detailed service reviews and benchmarking exercises;

“Given the budget development process is incrementally based, in order to find efficiencies, the approach often taken is to ‘de-prioritise’ expenditure.”

- Quality of Service Delivery – consideration of delivery options which can improve quality.

The Council have a preference for improved service delivery over cost reductions, but this is difficult in an environment where savings have to be found.

Information used to support decision making

The following information is used by Council to support decision making:

- Monthly and Quarterly budget monitoring reports (most reports are quarterly but some Trading Services are reported monthly);
- Service Review reports;
- Benchmarking cost data.

The following areas were identified where information could be improved:

- Management accounting information to understand the full costs of delivering services; and
- Performance information

Ideally financial and performance information should be held together in the one reporting suite. However identifying the right performance measures is the challenge.

Key barriers to cost reduction

The following barriers to cost reduction were identified:

- Cultural – encouraging changes to working practices and delivery models is a difficult process;
- Full costing information – there is limited understanding of the full costs of delivering some services and therefore it is difficult to estimate the value for money being achieved and extent for efficiencies;
- Demand Management – there is currently an ethos of universal service across the Council. This is expensive to deliver but there is reluctance to take steps to manage the demand for these services;
- Inflexibility of Central Government – Departmental funding often has restrictions in terms of how the money can be spent which discourages a collaborative delivery approach.

Flexing budgets in-year

Over-spends and under-spends are managed in a number of ways:

- Central contingency fund – can meet some overspend areas;
- Under-spends used to fund over-spends.
- Reduce controllable expenditure in-year.

How budgeting links with strategy and performance

Some limited performance information is provided simultaneously to the Cabinet with financial information, but there is difficulty in being able to use this information to support budget decision making (e.g. does poor performance mean you allocate more or less funding?).

One example of how performance and financial information was used successfully together by the Council is in respect of their ICT function. The ICT function was benchmarked using SOCITM data. This analysis concluded value for money was not being achieved and that the contract was being poorly managed. So the service was brought in-house and a 30% cost saving was achieved.

Background

Local Authority

c10,000 employees

Incremental Budgeting Approach

London Borough of Croydon - summary findings

- ***The Council is cutting costs and changing the way it operates, this means operational and budget planning are more inter-linked.***
- ***Moving to a more targeted budget approach opposed to an incremental approach***
- ***Efficiencies of 15% in the past three years and 15-20% in next three years***

Background

Croydon Council is currently in a period of considerable change. Firstly, it is implementing a series of significant cost reductions and in the past three years it has made savings of approximately 15%. In addition, over the next three year period, it is expected to find further savings of 15-20%.

Secondly, it is also undergoing significant organisational change as it consolidates support services across the Council into one function and is exploring shared services with other London Boroughs and authorities beyond the London region.

The budget process

The budget process is:

- Strategic approach– the process is managed corporately and direction is taken from the Cabinet[3] supported by the corporate management team. It is recognised that implementing significant spending cuts requires a 'strategic' approach.
- Customer priorities – the council's resource allocation is heavily driven by the priorities of local residents.
- 'Deep Dive' – this is moving towards Zero Based Budgeting (ZBB) which reviews spending over the previous 3 years on a line by line basis to justify current resource allocations;
- Programme Based Budgeting – the Council are currently exploring the potential to implement PBB within the budgeting process.

Governance around the Budget Development Process

Governance arrangements are as follows:

- Preparation – Service Area Management teams and Finance staff identify their spending needs and develop financial proposals and budgeting options (aligned to the stated political and resident priorities of the borough). In practice this is a continuous process throughout the year;
- Review – the Leader of the Council chairs 'challenge sessions' to assess the financial proposals developed across all budget areas to focus on needs and priorities.
- Approval – granted by the full Council (the approved budget then forms the basis of the Council Tax calculation).

[3] A Councillor is nominated as a Cabinet Member to represent specific portfolio areas and together with the Council leader they make up the 'Council Cabinet'.

"The choices of where to make savings were partly driven by statutory requirements but also by the need to ensure we provide the services that residents need most."

The budget is then communicated in a number of ways and through a number of channels such as the local media, the monthly Council Newsletter and published on the website this follows a detailed consultation process with local residents.

Linking Budget Planning and Operational Planning

A business partner type approach exists where dedicated teams support individual Service Areas and a dedicated accountant supports the Head of Service.

Central government support for budgeting

Central Government Grant represents approximately 50% of total Council income. Therefore in order to support budgeting and longer term financial planning, the Council has identified the need for greater certainty around levels of funding.

For example, it is likely that there will be no certainty on the amount Croydon is to receive from government for 2013/14 until about 3 months before the start of the financial year

How spending is prioritised

At a Council level, funding allocations are principally guided by the local priorities which are driven by the Cabinet.

Over the past three years, the priorities have been to make efficiencies and continue to provide statutory services. As a result the choices currently available to the Council are significantly reduced.

Other approaches used to identify priority areas include:

- Resident consultations – the Council have completed a number of consultation exercises, including the use of web based tools to invite the public to prioritise overall expenditure areas;
- The internal challenge process undertaken by the 'Council Cabinet' discussed above;
- Use of performance information from the corporate performance management system.

Analysis Techniques

The following analysis techniques are applied:

- Financial – NPV analysis typically undertaken as part of a capital project appraisal and one-off special projects (e.g. Invest to Save initiative);
- Non-Financial – undertake impact analyses such as consideration of implications on other areas of Council expenditure.

  Also with the proposed use of Programme Based Budgeting there will be an increased emphasis on outturn performance expectations.

  Moving forward there should be greater emphasis placed on the wider socio-economic implications of spending decisions.

Using the budget process to reduce costs

The following factors were identified as important in using the budget process to reduce costs:

- Ability to implement quickly – the ability to manage consultation and impact assessment processes in order to implement change programmes;
- Embedding good corporate behaviour - ensuring Service Area Heads and their budget managers act for the benefit of the entire Council. This can be achieved as follows:

"We are changing the way we operate and we are strong on planning.

But more certainty from Central Government around grant funding would aide our planning process."

– Strong leadership – to identify the areas which have greater need;

– Linking budget managers' Personal Appraisals to managing their budget and identifying efficiencies;

– Desire to maintain services – if efficiencies are not found the only alternative is to reduce the service.

- Council and public acceptance – both internally and externally, there is an acceptance that cost reductions are required.

- Having a corporate transformation process that enable services to access the support they needed to deliver reduction in costs.

- Public engagement – at the time of the Comprehensive Spending Review, the Council sought the public's view on priorities.

- Working with and learning from other Councils – the funding reductions have affected all councils and the Finance Directors of the 33 London Boroughs have established groups to share learning and establish projects to identify savings (such as a move to shared services across London).

Managing Interdependencies:

There is a requirement for Service Area spending proposals to explicitly set out the financial implications of their proposals on other areas of Council expenditure.

Furthermore, these points are also drawn out in the challenge process and raised by the Finance staff working in the individual Service Areas.

Flexing budgets in-year

As the budget becomes more continuous in nature, the process is more fluid. The Finance teams in each of the Service Areas monitor, on a monthly basis, forecast and outturn expenditure along with the tracking of decisions.

These monthly reports then make recommendations regarding amendments to the latest forecast budget to be approved by the Council Cabinet.

How Central Government can support LA's respond to financial pressures

The Localism Bill has been designed to give Local Authorities greater flexibility. For example, the recent localisation of council tax benefit gives local authorities greater flexibility to design their own schemes for council tax support. (However, Central Government has also reduced the support for council tax by 10%.)

How budgeting links with strategy and performance

The Council's Corporate Plan sets out a comprehensive list of key activities (associated with the strategic objectives). Each activity then has an associated performance measure.

The performance measures are reported monthly to Service Area Management and the Corporate Management team and are published quarterly.

This comprehensive performance measurement and reporting regime sits separately from the financial system. This information is used to inform budgeting decisions and is applied through, for example the 'challenge sessions' operated by the Council Cabinet.

Background

Metropolitan Local Authority

c9,000 employees

Gateshead Council - summary findings

- ***£75m savings targeted over the four year period to 2014/15***
- ***Extensive consultation with public on services the public need***
- ***Providing local bodies greater flexibility in the way they can spend central funding would break down the silo approach which currently exists***

Background

The Council is currently in the midst of a significant cost reduction phase, with a total of **approximately £75m of savings to be found over the four year period from 2011/12 to 2014/15** (of which £32m was removed from the budget in 2011/12 alone).

In support of the cost reduction measures, the Council is also implementing a significant organisational change programme, called the **Fit for Future Programme**. The reforms being implemented cover Back Office and Front Office services, procurement of services, maximising income and conducting a review of major service areas with a focus on performance management.

The Consultation Process

For their 2012-14 strategic budgeting exercise the Council developed a 4 stage approach to consult all relevant stakeholders. This more comprehensive approach successfully engaged with over 4,500 individuals, whilst previous online surveys only achieved response rates of 2,000.

Phase 1: Informing

Who?

Residents, Businesses, Councillors, Employees and other partners such as Other public sector bodies (police and health authorities etc.)

This phase communicated the following:

- the approach being taken to develop the budget;
- the services that would still be provided;
- research findings on residents attitudes to Council spending;
- how the views of stakeholders would be captured.

The communication channels included the Quarterly Publication, website, media releases and internal newsletters.

Phase 2: Consulting

Who?

Residents, Businesses and other partners.

A budget survey was launched through the Council's consultation portal to obtain the public's views on which non-statutory services should be prioritised.

The Council recognised the importance of making the impact of choices clear to the public and developed a series of Comprehensive Impact Assessments to support this process.

"The Council developed a 4 stage approach to consult all relevant stakeholders.

This approach successfully engaged with over 4,500 individuals, whilst previous online surveys only achieved response rates of 2,000."

Phase 3: Engagement

Who?
Specific user groups and stakeholders targeted

Following the identification of preferred choices, a 'deep dive' engagement would have occurred if services were to be altered, discontinued or delivery model changed.

Each engagement was undertaken on an individual basis, but with a view to minimising consultation fatigue.

Phase 4: Feedback

Who?
As per phase 1: Residents, Businesses, Councillors, Employees and other partners

The results of the consultation were used to inform the budgeting process and this was transparently communicated to all participants and the wider public. Individual user groups impacted also received specific feedback.

The budget process

Revenue expenditure:

- Incremental approach is used for annual budgets; but
- Driver-based budgetary adjustments made to the Medium Term Financial Strategy which is updated on an annual basis.

Transformation Projects

As part of the Fit for Future Programme, there is greater focus on 'strategic priorities' and 'statutory' requirements. This includes a thorough evaluation of all budget proposals with reference to:

- the Fit for Future Framework to determine if a proposal is discretionary or statutory; and
- alternative delivery approaches.

This shows a move towards Zero-based budgeting.

Capital expenditure:

- Incremental approach for existing/ ongoing work programmes (e.g. strategic maintenance, Equality Act works);
- For new projects, budget requirement is informed by initial design work and estimates, which draws on experience from similar projects where possible and relies upon the professional judgement of key officers.

  With increased pressures on revenue budgets and an increased reliance on borrowing to finance capital projects, capital budget planning has put increased emphasis on revenue implications.

Governance Arrangements

The overall direction and guidance for the budget comes from the Council's Cabinet. In addition, a Budget Coordination Group was established in June 2011 to bring together officers from across the Council to support the development of the budget. This group was responsible for:

- Delivery and analysis of the budget consultation; and
- Development of the Comprehensive Impact Assessments for each of the spending proposals

All councillors were engaged in the development of the budget proposals, through Advisory Groups, focus groups and members' seminars.

The Full Council then approve the budget.

"We valued the moves by Central Government to allocate grant funding for future years. This makes our planning process stronger.

We would like a similar process put in place from a capital prospective."

Linking Budget Planning and Operational Planning

In terms of the link between budgetary and operational planning:

- Revenue budgets are developed in significant detail and these budgets can be aggregated to service, departmental and organisational level. Service level budgets are linked to the Service Business Plans which forms the cornerstone of each Service Area's performance monitoring
- A rolling three year Capital Programme is agreed each year and monitored quarterly. A capital budget is prepared for each capital scheme and includes sources of funding and revenue implications.

Resources for Budgeting

Budgeting is undertaken within Financial Management; however, no specific budgeting function exists. The level of resources allocated to *developing* the budget is estimated at approx 5.2 FTEs (8.4% of the total Financial Management resource). The level of resources allocated to budget *monitoring* is estimated at 22.4 FTEs (36% of total FM resource).

Central government planning impact at Local Authority level

Central Government funding for local authorities represents a very significant source (nationally approximately 60%) of total funding. As a result the most important aspect of Central Government planning and budgeting that impacts upon a local authority is the financial settlement, in particular:

- the period covered; and
- the level of certainty that can be placed upon provisional settlement figures.

Therefore any further move towards multi-year settlements for local authorities would provide the Council with the ability to plan over the medium term with greater certainty. The current two-year settlement gives some assurance to local authorities, but scenario planning beyond current two-year settlement i.e. funding for 2013/14 and 2014/15 in MTFS is based on national picture announced as part of Spending Review. Indications are that government austerity measures will continue with further cuts to local government funding anticipated but the exact impact at a local authority level has yet to be confirmed definitively in the latest budget statement.

In 2011/12 about 34% of the capital external funding the Council received was confirmed as an annual settlement figure. In 2012/13 this figure rose to 45% of the capital external funding.

The other capital funding that we receive either follows a separate bidding process on a project by project basis (11/12 34%, 12/13 7%), or is confirmed as part of a multi-year allocation, usually over at least two financial years (11/12 32%, 12/13 48%).

Planning for capital projects could be more effective if funding allocations were confirmed for a longer period which would align more closely with the Council's Capital Programme planning cycle.

How spending is prioritised

The relative prioritisation of expenditure between and within Directorates is made by Council Cabinet and the Full Council. Elected members tend to be very aware of the views of their constituents and this is supported by exercises such as the annual budget consultation.

Cabinet members are allocated responsibility for a Service Area/ Directorate and this helps to ensure that the full impact of budgetary decisions across Directorates and Services are appropriately considered.

"The Total Place pilot was a valuable alternative to a top down silo approach...

...but there is currently no substantive replacement in the pipeline."

Overview of approach taken

Revenue expenditure – the individual directorates/ service areas develop budgetary proposals to put before the Cabinet (and subsequently Full Council). Techniques such as ranking (based on financial and non-financial factors) may be used within the directorates/ service areas as part of the process of developing these proposals.

Capital expenditure – the Capital Programme (approved by Cabinet and Council each year as part of a three year rolling programme) drives the capital budget. The Capital Programme is developed as follows:

- Service Areas/ Directorates put forward details of all high priority schemes and demonstrate how they link with the Council's corporate priorities;
- The Council's Capital Monitoring Group (comprising of directors and other key staff) consider the bids, initially in terms of current contractual commitments; and Health and Safety and other statutory requirements;
- Only after these obligations are met are further projects considered for inclusion in the Capital Programme. These additional projects typically require business plans which considers where appropriate, payback period; external funding; and borrowing.

Analysis techniques used

For revenue expenditure:

- Non-financial factors will often be crucial to prioritisation of budgetary proposals owing to the principle of democratic accountability of elected councillors to the electorate. Financial analysis techniques such as ROCE are typically not applicable for assessing revenue expenditure.

For capital expenditure:

- Non-financial factors used to prioritise the capital investment includes: service delivery; political preference and vision; statutory requirements; and alignment with regeneration strategies.
- Financial factors such as payback period are considered for 'Invest to Save' type projects. The value and term of the proposed scheme will often help to inform which financial techniques are used. For example significant schemes which involve potentially longer payback periods and increased risks, will also consider other detailed financial analysis and business planning.

Information used to support decision making

The following information is used by Council to make prioritisation decisions:

1. Monthly budget monitoring reports are provided to the budget holders and Director of Finance;
2. Quarterly budget monitoring reports provided to Council Cabinet; and

The Financial Management PACE Review (undertaken in April 2011) rated the financial information provided 2nd in the list of key activities provided to the Service Areas.

Using the budgeting process to reduce costs

The major barrier identified was the nature of settlements at the national level. Local bodies such as police authorities, strategic health authorities and local authorities receive funding from Central Government, often to address complex and overlapping issues. But the accompanying performance and accountability constraints to the individual Departments makes it

"The Council has developed an overall Policy, Planning and Improvement (PPI) framework, which it uses to determine priorities and the development of the Corporate Plan."

difficult for local bodies to work together or for individual councils to use funding from a number of sources in an integrated way.

The Total Place pilots offered a potential valuable alternative to this top-down silo approach but there is currently no substantive replacement in the pipeline.

Within the Council, the capital bidding process helps to identify potential cost reduction projects. As described above these are supported by business cases and assessed in terms of payback period etc.

Significant schemes in recent years have included energy efficiency initiatives which typically will amount to approximately 10% of the total capital investment in the current financial year.

Managing Interdependencies:

Cross-service financial issues are addressed at the weekly Group accountant meetings. An example of this is the analysis and discussion ongoing at present regarding the impact across services of asset rationalisation proposals being considered for the next budget.

Flexing budgets in-year

Revenue expenditure

The primary means of managing budgets following changing circumstances is via the contingency budget that is set as part of the annual revenue budget.

Highly significant unforeseen budgetary issues would be raised with the Strategic Director of Finance and the senior Financial Management team.

All of these issues would form part of the quarterly budget monitoring update to Cabinet and to council.

Capital expenditure

The Capital Programme Monitoring is formally reported on a quarterly basis following discussion with key project officers and contacts. The quarterly report is presented to the Capital Monitoring Group and then to Cabinet seeking formal approval to any significant variances.

The impact on the Capital Financing Requirement is also considered each quarter and links to decisions around the level and timing of borrowing.

How budgeting links with strategy and performance

The Council has developed an overall Policy, Planning and Improvement (PPI) framework, which includes the following components which are used to determine priorities and the development of the Corporate Plan:

- Strategic Needs Assessment;
- The use of performance management information to deliver continuous service improvement and inform policy development; and
- The development of Service Business Plans by each Head of Service which includes historic service performance information.

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