

Public sector

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commission



# World class financial management

A discussion paper

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# Summary

## Financial management matters

- 1 Financial management:
  - is an essential element of good corporate governance;
  - forms part of the firm foundations of an organisation, underpinning service quality and improvement; and
  - is the basis of accountability to stakeholders for the stewardship and use of resources.
- 2 It is about managing performance and achieving an organisation's strategic objectives, as much as about managing money.
- 3 Financial management is a key management discipline. It is something that all non-executives and managers within an organisation are responsible for, individually and collectively. It is not just the job of the director of finance and his or her staff.
- 4 The public sector faces a rapidly changing and increasingly complex operational environment and, given the special accountabilities attached to the stewardship and use of public money, all public bodies need to rise to the challenge of improving financial management<sup>1</sup>.

## The aims of this discussion paper

- 5 Against this background, the Commission has developed this discussion paper to stimulate debate across public services and among finance professionals about what standards of financial management the public sector should aspire to over the longer term. It does not attempt to set those standards or to define a benchmark against which public sector bodies can, or should be, judged in the short term, and it is not meant to be comprehensive. This paper is high level in nature and is not intended to be a practical guide to how financial management in the public sector might be improved.

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<sup>1</sup> For example, see the Commission's annual reports on the local audit regime, *Stewardship and Governance*.

- 6 In developing this paper, we worked with PricewaterhouseCoopers (PwC), our largest private sector partner, to identify leading edge and best practice examples of different aspects of financial management. These examples were drawn from PwC's knowledge sources, which reflect their learning and extensive experience in providing audit and advisory services across the world.
- 7 We want to encourage readers to think about the issues raised in this paper from a different perspective. It is for this reason that we have chosen to highlight case studies drawn from the private sector or overseas. However, we recognise that public sector bodies are subject to different operational constraints from private sector bodies. We believe that the principles of good financial management are universal, and apply equally across the private, voluntary and public sectors. In that context, what do these case studies drawn from the private sector and different countries have to teach us?
- 8 We are not suggesting that the public sector should slavishly adopt private sector practice. We recognise that financial management arrangements within an organisation must primarily be fit for purpose and proportionate, and that the standards highlighted in the case studies may not necessarily be appropriate for, or transferable to, all organisations. They also cannot be achieved overnight. The process of achieving world class standards of financial management in the public sector will necessarily take the form of a journey with various staging posts along the way. We also recognise that achieving these standards necessarily involves costs, which have to be justified in terms of additional benefit, through the better use of resources and enhanced accountability.

## The structure of this discussion paper

- 9 We have focused on five key themes of financial management, each of which is considered in turn:
  - financial governance and leadership;
  - financial planning;
  - finance for decision making;
  - financial monitoring and forecasting; and
  - financial reporting.

## Financial governance and leadership

- 10 The quality of financial governance and leadership – the tone from the top – is as important as processes in securing world class financial management. Top management (both executives and non-executives) within the organisation needs to be financially literate and able to understand fully the financial environment in which the organisation operates. It needs to foster an organisational culture in which individual and collective responsibilities for the stewardship and use of resources and financial accountability to external stakeholders are taken seriously and financial skills are valued and developed. The development of the organisation's strategic and corporate plans needs to be informed by a proper understanding and appreciation of the financial implications.

## Financial planning

- 11 Financial planning needs to be linked to the organisation's strategic and corporate planning processes – the financial plan (budget) is simply a quantitative expression of a plan of action. As such, financial plans should reflect the organisation's key strategic priorities. Annual financial plans, integrating current expenditure plans and investment programmes, with cashflow and balance sheet projections, should be developed in the context of a longer-term financial strategy, which supports the organisation's strategic plan.

## Finance for decision making

- 12 In developing an organisation's strategic and corporate plans, top management needs to consider the value for money achieved by allocating resources to different activities. It also needs to have a thorough understanding of the financial implications of current and potential alternative policies, programmes and activities. This should be based on an analysis of their cost profiles and cost drivers and of how those costs will behave in different circumstances. It also needs to understand the whole-life costs associated with capital investment.

## Financial monitoring and forecasting

- 13 If the organisation is to meet its strategic and operational objectives, top management needs to assure itself that financial performance to date and forecast financial outturn for the year are in line with the plan, including cashflow and balance sheet projections. Variances should be identified as soon as possible, so that management can either take corrective action to manage unfavourable variances or apply any favourable variances to corporate priorities. It also needs to monitor and review the underlying costs of the

organisation's key activities and how these are profiled over time. Financial information needs to be integrated with non-financial performance and activity information. Together, such information forms the basis for financial forecasts and enables value for money to be monitored. The financial information used both for setting the budget and internal accountability, monitoring and forecasting throughout the year should be derived from the same systems that are used to generate the results reported externally in the organisation's statutory financial statements.

## Financial reporting

- 14 To run the organisation effectively, top management needs up-to-date financial and non-financial performance information on a timely basis. It should be presented in a form that is tailored to user needs, is easy to understand and highlights the key financial issues that they need to be aware of. For its part, top management needs to provide timely, accurate and balanced information about its stewardship and use of resources and its non-financial performance to the organisation's different stakeholders. Such information should be presented in a form tailored to meet their needs.

## Development of this paper

- 15 In developing the discussion paper we have reviewed the extensive body of literature on financial management, as well as drawing on PwC's knowledge sources. What has been striking as we have carried out the research is that there is a broad measure of agreement about the basic principles of financial management, confirming that they are truly universal. What distinguishes world class performance, and thereby serves to define world class standards of financial management, is how these principles are applied in practice. In world class organisations, these principles are fully embedded and the basic routines and processes are carried out more quickly, more reliably and more frequently. Achieving this level of performance is the challenge that faces the public sector.

## What next?

- 16 We hope that the ideas set out in this paper, and the case studies that illustrate them, will stimulate public bodies to challenge their current practice and thinking about financial management, regardless of their size or type. The Commission's focus is local government and the NHS in England, but we hope that the ideas set out in this paper will be of wider interest and that they will promote discussion across the wider public sector.

- 17 We would welcome comments on the ideas set out in this discussion paper. The final section outlines our conclusions on the implications of our research for financial management in local government and the NHS. It also includes a series of questions to stimulate debate.
- 18 The need to extract the maximum value from the scarce resources invested in public services puts a premium on standards of financial management in public bodies. The Commission has expressed concern about aspects of financial management in both local government and the NHS. Against that background we will continue, working with a range of partners, to focus on the practical improvements that, in our view, need to be made to financial management in local government and the NHS.
- 19 The Chartered Institute of Public Finance and Accountancy (CIPFA) is committed to developing further its financial management model to reflect emerging best practice. We welcome that commitment, as this model underpins the criteria our appointed auditors are applying in their use of resources judgements for Comprehensive Performance Assessment (CPA) and the Healthcare Commission's assessment model. In central government, HM Treasury is committed to achieving world class standards of financial management. We welcome this objective, which we believe should apply across the wider public sector. We look forward to working closely with both CIPFA and HM Treasury and with other stakeholders, such as the NAO, to take forward the ideas set out in this paper, to define best practice and drive up standards of financial management in the public sector.
- 20 For its part, the Commission will use the high-level principles set out in this discussion paper to inform the development of our future work on financial management. In light of both the response to this paper and the results of our appointed auditors' work on the ground (in particular, their use of resources judgements for CPA and the Healthcare Commission's assessment model), we intend to build on these principles to develop a series of more practical studies and guidance on particular aspects of financial management in local government and the NHS.
- 21 We believe that the ideas set out in this discussion paper provide a good framework within which we can develop our future work in this area.
- 22 Do you agree? Please send us your comments and contributions to **[worldclassfm@audit-commission.gov.uk](mailto:worldclassfm@audit-commission.gov.uk)**.

# Introduction

**Good financial management is an essential element in the delivery of high-quality public services. Against the background of a rapidly changing and increasingly complex operational environment, public services need to rise to the challenge of improving financial management. Given that the principles of financial management are universal, what can public services learn from leading edge practice in the private sector and from overseas?**

## Financial management matters

- 23 Financial management matters. It is integral to an organisation's corporate governance arrangements and, as such, has been defined by CIPFA as 'the system by which the financial aspects of a public body's business are directed and controlled to support the delivery of the organisation's goals'<sup>1</sup>. In other words, it is about managing performance and achieving an organisation's strategic objectives, as much as about managing money. As such it needs to be at the top of the agendas of public sector bodies' boards (or their equivalents), chief executives and their top management teams.
- 24 Good financial management is an essential element of good corporate governance and forms part of the firm foundations of an organisation, underpinning service quality and improvement. It also forms the basis of accountability to stakeholders for the stewardship and use of resources. Good financial management may not be visible, but the lack of it is very noticeable, very quickly.
- 25 Financial management is a key management discipline. It is not just what accountants do, but something that every manager within an organisation is responsible for. In that respect, an excellent finance function is a necessary, but not sufficient, condition of good financial management within an organisation, although it obviously has a key role to play as a catalyst for improving financial management.
- 26 The public sector faces an operational environment that is changing rapidly and increasingly complex. Against that background, standards of financial management that may have been good, or good enough, in the past, will not be good enough in the future. Given the special accountabilities attached to the stewardship and use of public money, all public bodies need to rise to the challenge of improving financial management.

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<sup>1</sup> CIPFA, *The CIPFA FM Model: Improving Financial Management and Effectiveness in the Public Service – Introducing the Model*, 2004.

## The aims of this discussion paper

- 27 The Commission has noted that HM Treasury has set itself an objective to ‘achieve world class standards of financial management in government’<sup>1</sup>. We believe this objective should apply across the public sector. However, there is no generally accepted set of financial management standards and they are certainly not written down anywhere.
- 28 The Commission has therefore developed this discussion paper to stimulate debate across public services and among finance professionals about what achieving world class standards of financial management in government might mean in practice and, more broadly, what standards of financial management the public sector should aspire to over the longer term. It does not attempt to set these standards or to define a benchmark against which public sector bodies can, or should be, judged in the short term. The paper is high level in nature and is not intended to be a practical guide to how standards of financial management in the public sector might be improved.
- 29 In developing this paper, we worked with PwC, our largest private sector partner, to identify leading edge and best practice examples of different aspects of financial management. These examples were drawn from PwC’s knowledge sources, which reflect their learning and extensive experience in providing audit and advisory services across the world.
- 30 We want to encourage readers to think about the issues raised in this paper from a different perspective. It is for this reason that we have chosen to highlight case studies drawn from the private sector or overseas. However, we recognise that public sector bodies are subject to different operational constraints from private sector bodies. Public bodies have to manage their business within a political environment, resources are in effect rationed and the ability to generate additional resources is limited. But the private sector also has to cope with the inherent uncertainties of the market. The financial management arrangements put in place are, in part, about managing those uncertainties. We believe the principles of good financial management are universal, and apply equally across the private, voluntary and public sectors. In that context, what do these case studies drawn from the private sector and different countries have to teach us?
- 31 We are not suggesting that the public sector should slavishly adopt private sector practice. Financial management arrangements within an organisation must primarily be fit for purpose and proportionate. This means that what is appropriate for a large

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<sup>1</sup> HM Treasury, *Technical Note for the HM Treasury Public Service Agreement 2005–2008*, 2004.

multinational may not necessarily be appropriate for, or transferable to, smaller organisations; equally, any organisation's financial management arrangements will reflect its specific regulatory and operating environment and the nature of its business. Achieving world class standards will involve costs, in terms of investing in people and systems. These costs have to be justified in terms of additional benefit, in terms of better use of resources and enhanced accountability.

- 32 In this respect, we also acknowledge that world class standards of financial management cannot be achieved overnight. There are significant practical and, in some cases statutory, obstacles to be overcome in each of the different parts of the public sector. The process of achieving world class standards of financial management in the public sector will therefore necessarily take the form of a journey, with various staging posts along the way.

## The structure of this discussion paper

- 33 This discussion paper does not attempt to be comprehensive<sup>1</sup>. Rather we have focused on five key themes of strategic financial management:
- financial governance and leadership;
  - financial planning;
  - finance for decision making;
  - financial monitoring and forecasting; and
  - financial reporting.
- 34 These are the aspects of financial management with which public sector bodies' boards (or their equivalent) and top management teams need to engage most directly.
- 35 Each of these themes is considered in turn in the sections below. At the beginning of each section we outline briefly what seem to us to be the key issues and challenges relating to each theme in local government and the NHS. We then draw our conclusions together in a final section, in which we pose a series of high-level questions. We would welcome your views on these questions.

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<sup>1</sup> For example, we have not covered transactional processes or systems of internal financial control. This does not mean that these underlying processes and controls are not important in themselves – indeed, they form an essential part of the framework of financial management within an organisation.

## Development of this paper

- 36 In developing this discussion paper we have reviewed the extensive body of literature on financial management, as well as drawing on PwC's knowledge sources. A list of suggested further reading is included at the end of this paper.
- 37 What has been striking as we have carried out the research is that there is a broad measure of consensus about the basic principles of financial management, confirming that they are truly universal. What distinguishes world class performance, and thereby serves to define world class standards of financial management, is how these principles are applied in practice. In world class organisations, these principles are fully embedded and the basic routines and processes are carried out more quickly, more reliably and more frequently. Achieving this level of performance is the challenge that faces the public sector.

## What next?

- 38 We hope that the ideas set out in this paper, and the case studies that illustrate them, will stimulate public bodies to challenge their current practice and thinking around financial management, regardless of their size or type. The Commission's focus is local government and the NHS in England, but we hope that the ideas set out in this paper will be of interest and promote discussion across the wider public sector.
- 39 CIPFA is committed to developing further its financial management model to reflect emerging best practice. We welcome that commitment, as this model underpins the criteria our appointed auditors are applying in their use of resources judgements for CPA and the Healthcare Commission's assessment model. In central government, HM Treasury is committed to achieving world class standards of financial management. We welcome this objective, which we believe should apply across the wider public sector. We look forward to working closely with both CIPFA and HM Treasury, and other stakeholders, such as the NAO, to take forward the ideas set out in this paper, to define best practice and drive up standards of financial management in the public sector.
- 40 For its part, the Commission will use the high-level principles set out in this discussion paper to inform the development of our future work on financial management. In light of both the response to this paper and the results of our appointed auditors' work on the ground (in particular, their use of resources judgements for CPA and the Healthcare Commission's assessment model), we intend to build on these principles to develop a series of more practical studies and guidance on particular aspects of financial management in local government and the NHS.

# 1



## Financial governance and leadership

The quality of financial governance and leadership within an organisation, the tone from the top, is critical to achieving world class financial management. Clearly, good basic systems, processes and controls are also important, but it is the overall financial culture of the organisation that really makes the difference.

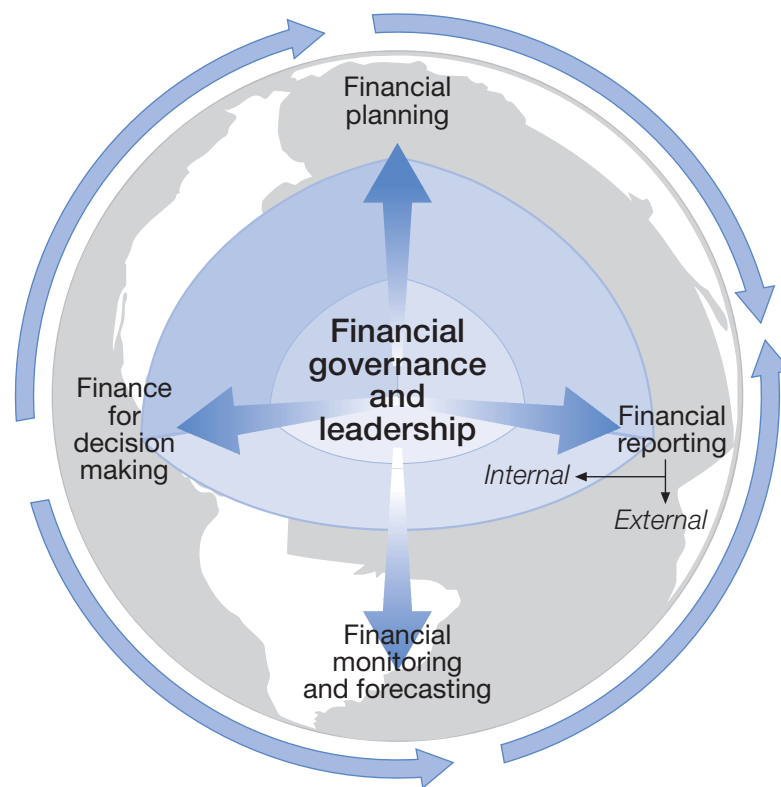
The quality of financial governance and leadership within an organisation, the tone from the top, is critical to achieving world class financial management. Clearly, good basic systems, processes and controls are also important, but it is the overall financial culture of the organisation that really makes the difference.

In most public sector organisations, the chief executive is the accountable officer for financial performance. Most organisations also appoint a designated director of finance (FD). Normally, this individual will be a member of the board or equivalent. In most respects this is a strength, but the existence of such a formally designated post can also have its drawbacks. It tends to encourage the view that finance is the FD's problem and not something that other members of the top team need to worry about or, alternatively, that where things go wrong it is that individual's responsibility to sort them out. We can point to a number of cases where this attitude contributed to corporate failure. All members of the top management team, both executive and non-executive, need to accept individual and collective responsibility for the stewardship and use of resources and for financial accountability to external stakeholders. Clearly, the designated FD has a key role to play, but as part of a collective effort.

- 41 The quality of an organisation's financial governance and leadership is as important as its processes in securing world class financial management and will impact on all other areas (**Figure 1**). For example, the accuracy of past forecasts will impact on financial planning for future periods.

**Figure 1****Five key themes of strategic financial management**

Financial governance and leadership is at the heart of world class financial management.



*Source: Audit Commission*

42 Factors that impact on financial governance and leadership are:

- culture;
- development of financial skills; and
- challenge on financial matters.

## Culture

- 43 The tone set by top management (both executives and non-executives) has a major influence over the quality of financial management within an organisation. Top management needs to create and maintain an organisational culture that takes seriously individual and collective responsibilities for the stewardship and use of resources and financial accountability to external stakeholders. This culture should value and develop financial skills.
- 44 The whole organisation needs to recognise that it has collective responsibility for financial matters, and that it is not just the responsibility of the FD and the finance department. The FD is only one member of an integrated management team. Top management needs to be financially literate and fully understand the financial environment in which the organisation operates. It must set out clearly the collective and individual responsibilities for financial management and related delegations need to be set out clearly in a framework of accountability for financial matters. Top managers must also ensure that they are seen to be taking their financial management responsibilities seriously.
- 45 Although responsibility for financial management is a collective one, one member of the top team should have personal responsibility and accountability for leading and advising colleagues on financial issues. This will usually be the FD, who should normally be a qualified member of a professional accountancy body.
- 46 The FD will have a range of personal and corporate roles and responsibilities. These have been characterised by the Institute of Chartered Accountants in England and Wales' (ICAEW) Faculty of Finance and Management (**Box A**).

**Box A****A new framework for measuring financial management**

External relationships	Board member	Head of finance	Professional
Financial reporting	Corporate governance	Management information systems	Integrity
Narrative reporting	Internal controls	Tax	Continuing professional development
Law	Strategic oversight	Business support	Corporate conscience
Investor relations	Risk management	Transaction management	Credibility
External audit	Resource allocation	People development	
Corporate finance (eg, mergers and acquisitions)	Performance measurement and management	Treasury (eg, cash and working capital management)	
Communication			
People management			

*Source: C Jackson, Faculty of Finance and Management, ICAEW, 2005*

- 47 The board or equivalent may establish a sub-committee to be responsible for financial management issues (for example, a finance committee). However, it is important to emphasise that, while the sub-committee may have more time and resources to focus on finance issues, ultimate responsibility rests with the board or equivalent and cannot be delegated.
- 48 An essential element of good financial governance is an effective audit committee. One of the objectives of an audit committee is to contribute independently to the corporate governance of the organisation and to provide assurance to the board or equivalent that there is an effective framework of internal control. This will include monitoring the integrity

of the financial statements, reviewing the internal financial control system and considering the planned activity and outputs of both internal and external audit. This will be achieved most effectively by selecting committee members who have an appropriate mix of skills, including recent and relevant financial experience, knowledge of risk management/audit/accountancy and an understanding of corporate governance issues. In particular, it is important that the committee chair commands respect within the organisation and has sufficient credibility to drive forward the work of the committee.

- 49 An excellent finance team is essential, but good financial management cannot be achieved by the finance department alone. The finance team has a role in supporting and advising operational managers on financial matters, but these operational managers remain accountable for the financial performance of their own service area. This principle should be reinforced through setting objectives for financial performance within operational managers' performance objectives, and then ensuring that they are held to account for performance against them. Finance staff's objectives should include the need to support and advise their colleagues. This will ensure an organisational culture in which individual, as well as collective, responsibility for financial management is developed and fostered.
- 50 In order for a finance team to be able to provide suitable financial support, the finance department itself needs to be adequately resourced, informed and have a culture of best practice. Finance staff need to be appropriately qualified. They should have regular training and undertake continuing professional development. There should be a clear strategy for developing the department (for example, training plans, succession planning and plans for developing capacity). Robust quality assurance arrangements should be put in place, covering all aspects of the work of the finance function. A strong finance team will also provide challenge and help to ensure accurate reporting of performance against plans.

## **Development of financial skills**

- 51 Staff outside the finance department also need to develop their financial skills. The development of the organisation's strategic and corporate plans must be informed by a proper understanding and appreciation of the financial implications of the objectives and planned actions.

- 52 As CIPFA has pointed out, 'Financial management responsibilities are now widely diffused and are not the exclusive interest of the director of finance. This demands a high degree of financial literacy from managers throughout the organisation'<sup>1</sup>. With this in mind, top management needs sufficient financial training to enable it to carry out its role effectively. The board or equivalent should review its own effectiveness and a tailored training programme should be developed to address any areas of weakness. Each organisation should also consider the level of financial skill required for different tiers of management below board level or equivalent, and ensure that regular financial training is provided accordingly. This should link clearly to the organisation's accountability framework and scheme of delegation.
- 53 Basic financial literacy and competencies are essential if managers are to understand the financial consequences of any decisions they take. While the finance department can facilitate the understanding of financial information, this is no substitute for the basic financial literacy and competencies required by all staff, including top management.

### Challenge on financial matters

- 54 All organisations should foster an environment where there is routine challenge of financial assumptions and financial performance.
- 55 Across the organisation there should also be a culture where operational managers are comfortable raising queries and contributing to the development of financial strategies and plans. This challenge could help to prevent issues arising and assist in responding in a timely manner to adverse variances from budget. Finance staff will help prepare strategies, budgets and financial information, but will not be as knowledgeable as operational managers about potential service developments, changes in activity level, the likelihood of specific events occurring and other operational matters.
- 56 Challenge on financial matters is crucial at board level or equivalent. Non-executive and executive directors should provide constructive challenge to financial plans and financial performance. This reinforces once again the need for members of the board or equivalent to have financial skills.

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<sup>1</sup> CIPFA, *The CIPFA FM Model: Improving Financial Management and Effectiveness in the Public Service – Introducing the Model*, 2004.

- 57 External and internal auditors are another mechanism for challenging the organisation on financial plans, assumptions and performance, as well as financial procedures and processes. Auditors' reports should be considered by the organisation's audit committee in the first instance, but reports that highlight significant issues or failings should also be considered by the organisation's board or equivalent. Action plans relating to these reports should be incorporated into the organisation's own performance management system to ensure that the actions are implemented and monitored as appropriate and are owned by the organisation.
- 58 Financial management arrangements themselves should be subject to challenge and review by top management to ensure that they remain robust in a constantly changing environment and are fit for purpose.

# 2



## Financial planning

In the public sector, the annual planning or budgeting process tends to dominate the financial cycle. It consumes a significant amount of time, effort and resources, but often results only in a relatively minor shift of resources at the margins. In many public sector bodies, the annual financial planning process is often only loosely connected to the strategic and service planning processes.

**In the public sector, the annual planning or budgeting process tends to dominate the financial cycle. It consumes a significant amount of time, effort and resources, but often results only in a relatively minor shift of resources at the margins. In many public sector bodies, the annual financial planning process is often only loosely connected to the strategic and service planning processes.**

**Within the public sector, the focus also tends to be on short-term financial planning, ie, the annual budget. But key developments, such as the introduction of three-year financial settlements in local government and of payment by results in the NHS, mean that public sector bodies increasingly need to plan their financial strategies over a longer time period and link these directly to strategic and service priorities.**

59 In world class organisations, financial planning:

- is delivered through a robust planning process;
- is medium to long term; and
- integrates capital, revenue and treasury management planning.

## **Robust planning process**

- 60 Financial planning and budgeting should be linked directly to the organisation's strategic and corporate planning processes. While the budget normally relates to a single financial period, financial planning is not just about predicting the numbers over a particular time period. It is about the whole financial process, including links with other planning cycles in the organisation (for example, service planning) and arrangements for monitoring financial performance, including by whom and how the organisation will respond to variances.
- 61 The organisation's process for preparing a financial plan and budget should be clearly set out and understood by all those involved in management from the top down. Where necessary, this should also include external stakeholders, for example, bodies that have joint arrangements or partnerships with the organisation.

- 62 The process should meet business needs and avoid being over-engineered – as noted by the ICAEW, ‘it is important that the mechanics of budget preparation are made as straightforward and efficient as possible’<sup>I</sup>. Traditional budget processes can take up a large amount of time and resources, resulting in a budget that is already out of date before it is finalised and is cumbersome to update. Other approaches to budgeting include rolling forecasts or rolling budgets, which take less time to prepare and are more flexible<sup>II</sup>.

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### Case study 1

In Australia, the federal government's Department of Finance and Administration uses an integrated planning and reporting framework to underpin a culture of financial management and accountability.

A high-level, one-page Corporate Plan containing key objectives and performance measures is refreshed annually by the Executive Board, chaired by the Secretary of the Department, as the top-down element in setting the organisation's values and directions. Business Groups then prepare four-year business plans specifying the contribution that each Business Group will make to the organisation's objectives, underpinning assumptions and risks, and the strategies and resources necessary to achieve those objectives. The Executive Board reviews and approves business plans and detailed annual budgets prepared for each cost centre. Business plans and budgets link directly to individual performance agreements and remuneration.

Flash reports of performance to budget are prepared within three days of month end. Comprehensive management reports incorporating detailed variance analysis and full-year forecasts are prepared and reviewed monthly by the Executive Board. Performance against business plan objectives, budgets and forecasts feeds into individual mid-year and full-year performance assessments and bonus payments.

*Source: Auditor-General for Australia*

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<sup>I</sup> John Fanning, *21st Century Budgeting*, Faculty of Finance and Management, ICAEW, 2000.

<sup>II</sup> CIPFA is developing guidance on how to apply this approach in the public sector, which is due to be published in 2006.

- 63 Following the completion of the financial planning and budgeting process, the outcomes and strategy agreed by the board or its equivalent needs to be communicated to relevant staff, to ensure that they understand their role and responsibility for delivering them.
- 64 The budget and longer-term financial plan is a quantitative expression of the organisation's plan of action and as such should reflect the organisation's key strategic priorities and objectives both for the year and the longer term. The Chartered Institute of Management Accountants (CIMA) and the ICAEW describe a budget as 'a road map detailing where the business is, where it wants to go and how it can get there'<sup>1</sup>. For this reason, financial planning cannot be carried out in isolation from the service-planning process; the two must be integrated. The budget should be developed in the context of the organisation's longer-term financial strategy.

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## Case study 2

The Toyota Motor Corporation of Japan builds budgets around the company's full business cycle, rather than on an annual financial planning and reporting schedule. This results in rolling budgets that enable managers to plan for longer-term projects and avoid reactive cuts when business plans, or the economy, hits a trouble spot.

*Source: PricewaterhouseCoopers*

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- 65 Clearly, the financial plan and budget should be robust and realistic. Top management has a key role in challenging the underpinning assumptions and the robustness and realism of forecasts.
- 66 Financial planning should include modelling of different scenarios (for example, best case, worst case and most likely) not only to predict financial outcomes, but to allow top management to develop strategies to avoid or mitigate the risks identified and be proactive about managing them. This should include identification and scoping of expected financial pressures and profiling of costs and cashflow over time to identify when action should be taken or when additional resources may be required. It will also allow for reasonable contingency reserves to be built into financial plans. For these reasons, financial planning should also be integrated with risk management within the organisation, to ensure that the financial plans take account of the organisation's risk registers and strategies and that these in turn fully reflect financial risks.

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<sup>1</sup> CIMA and Faculty of Finance and Management, ICAEW, *Better Budgeting*, 2004.

- 67 It is vital that the finance department understands the services that it is supporting. A key part of the financial planning cycle is for finance staff to go out and meet the people who are involved day-to-day with managing and delivering services. These are the people who will know most accurately the likely performance of each service area, and this information will be crucial for predicting different scenarios for inclusion in financial plans and the budget. The reliability and realism of underlying assumptions and the accuracy of data (for example, assumed activity levels) is critical.

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### Case study 3

3M's process for developing budgets once used a bottom-up approach, consolidating plans from various divisions to create the overall corporate plan. The company has moved to a top-down approach and requires business units to develop plans to meet management's strategic goals.

At the corporate level, the strategic planning process begins in March and ends in July. Five-year financial plans are prepared for the company's seven groups, comparing five-year historical trends to five-year improvement plans. The plans are reviewed and validated through a series of meetings attended by the Chief Executive Officer (CEO) and other senior management. Specific targets for the upcoming year are then developed for each operating unit, which are again reviewed by the CEO and a small group of top managers. After this, group and division goals are negotiated and improvement plans finalised. The company relies more on objectives than financial measures and focuses on the actions needed to meet those objectives.

*Source: PricewaterhouseCoopers*

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## Medium- and longer-term financial planning

- 68 For an organisation to manage its financial health effectively, an annual budget is not sufficient. It needs to develop its budget in the context of a longer-term financial plan that includes a rolling forecast (for example, covering three to five years) that is updated at least annually. A practical example of long-term planning in the public sector comes from New Zealand, where local government bodies are required by law to produce ten-year plans, which include financial forecasts.

- 69 Good planning can ensure that short-term fixes are not achieved at the expense of long-term sustainability<sup>1</sup>. Long-term planning enables top management to see the impact of trends over a number of years and supports longer-term decision making (for example, the impact of building a new facility and the associated effect on revenue and expenditure over an extended period).

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### Case study 4

Several years ago, Volvo Cars, now a unit of Ford Motor Company, abandoned its annual budgeting process in favour of rolling forecasting. Previously, managers at the Swedish motor vehicle manufacturer spent about 20 per cent of their time on annual budget preparation, leaving little time for strategy and action planning. Today Volvo's managers review and update strategy in several distinct cycles:

- each month, they prepare flash forecasts that look one quarter ahead;
- each quarter, they update a two-year rolling forecast; and finally,
- each year they revise the four-year and ten-year strategic plans. Together, these forecasts provide Volvo with core information for monthly strategy reviews and program development, enabling the company to keep pace with changing market conditions.

*Source: PricewaterhouseCoopers*

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- 70 As part of the process of developing a long-term financial plan, top management needs to be clear about its strategy and priorities. It must identify areas where it needs to invest or disinvest in the longer term, whether in terms of revenue or capital. When preparing this longer-term plan, the board or equivalent should focus on the organisation's strategic objectives, where agreeing additional or shifts in investment can bring about real improvements in performance and service delivery. By focusing on the longer-term objectives, the board or equivalent can avoid spending too much time looking at the year-on-year shifts in budgeted income and expenditure that are likely to have only limited impact when compared with the overall budget and what this sets out to achieve. The financial plan should clearly set out the sources of funding to deliver the strategic objectives.

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<sup>1</sup> Audit Commission, *Planning to Succeed: Service and Financial Planning in Local Government*, 1999.

- 71 Longer-term financial planning should include a rolling programme reviewing the major service areas within the organisation. The annual planning process should follow this up by assessing the extent to which plans have been delivered, why variances occurred, and whether planned benefits have been realised. This information should be used to produce better and more accurate plans in future periods.
- 72 The financial planning process itself should be the subject of continuous review. CIMA and the ICAEW note that 'research shows that over 60 per cent of companies claim they are continuously trying to improve the budgeting process to meet the demands set for management in creating sustainable value'<sup>1</sup>. A world class organisation should be constantly revising and improving its financial planning process so that it continuously adds value to the organisation wherever possible.

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### Case study 5

Borealis A/S was formed in 1994 from the merger of Statoil and Neste Chemicals. The newly established Danish petrochemical company immediately faced the challenge of consolidating two budgeting processes into one, combined with turmoil in the oil industry, which was causing some companies to experience lower margins.

A new financial management process was needed, one that could handle a larger operation as well as be flexible enough to respond to market changes. As the traditional annual budget process took an average of six months to complete, the cyclical nature of product prices and raw materials in the petrochemicals industry meant that the budget quickly became irrelevant.

The company therefore moved away from the traditional annual budgeting process, in favour of preparing forecasts that looked five quarters ahead. The processing time was reduced to four days each quarter – 5 per cent of the time required under the old budgeting procedure.

To further improve the financial-planning process, the budgeting process is integrated with a balanced scorecard system that focuses on longer-term goals.

*Source: PricewaterhouseCoopers*

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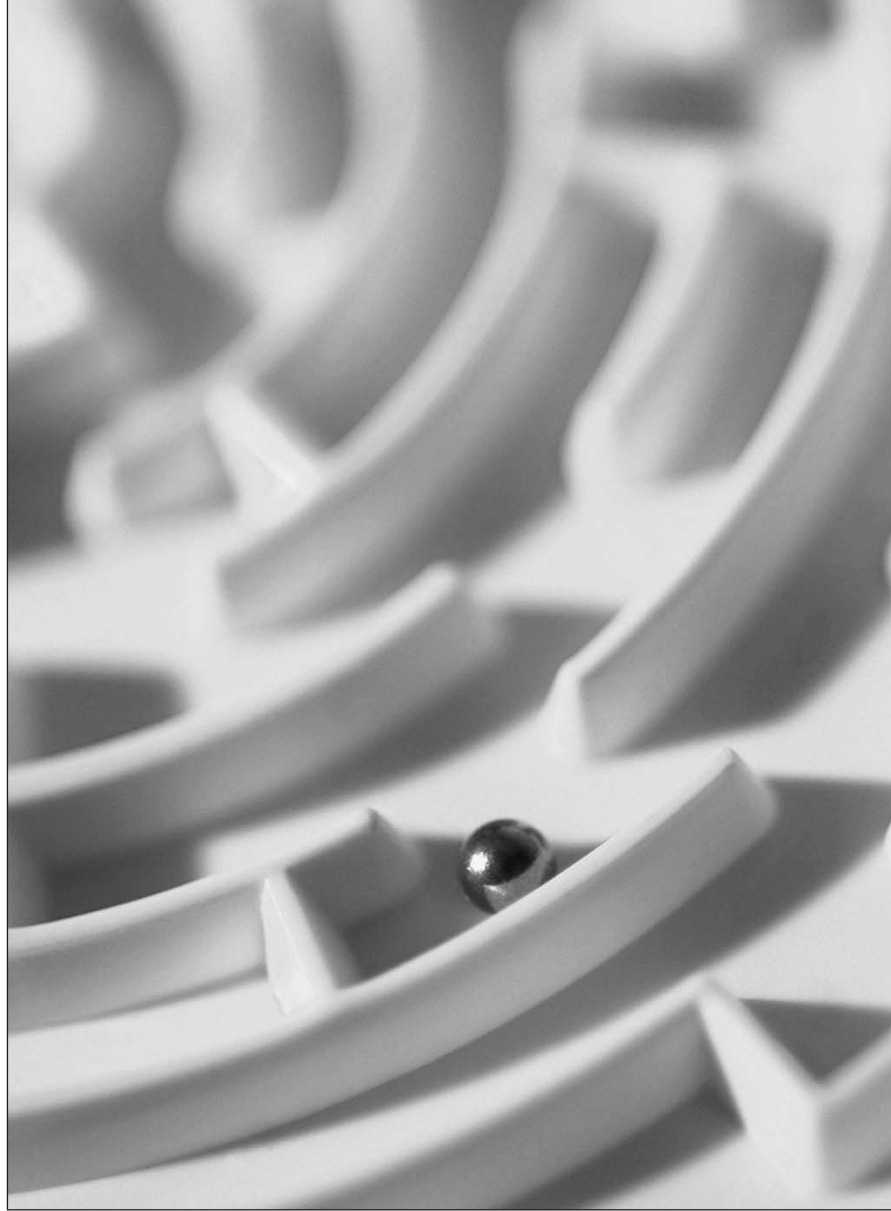
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<sup>1</sup> CIMA and Faculty of Finance and Management, ICAEW, *Better Budgeting*, 2004.

## Integrated planning

- 73 Financial planning should be an integrated process, considering the impact on all the main financial statements (income and expenditure account, balance sheet and cashflow statement). None of the primary financial statements can be considered in isolation, instead the impact of financial plans, budgets and strategic objectives should be linked through to all of them. The impact of major investment decisions (capital and revenue) should also be clearly apparent.
- 74 The financial plan should include a clear assessment of the organisation's cashflow requirements and how it will meet them over the year, including a consideration of contingency measures should any unforeseen pressures arise. Cash is the lifeblood of any organisation and cashflow forecasting, reporting and management should be given due priority. The organisation needs to manage its working capital to ensure that there is enough cash to meet its responsibilities as they fall due, without maintaining excessive balances. Cashflow forecasts, monitoring reports and any potential issues should be reported regularly to the board or equivalent.
- 75 The financial plan should be prepared in a format as close to that used for external reporting as possible so that top management can see the predicted outturn position as it will appear to external stakeholders. This should again cover all the primary financial statements. The same format should also be used for the highest level of financial reporting at the organisation. Not only does this provide consistency and allow for effective comparisons, but it should also ensure a speedier closedown of year-end accounts and more timely reporting to external stakeholders.

# 3



## Finance for decision making

Clearly, in the private sector, an organisation needs to understand its cost profiles, drivers and behaviours if it is to set prices for its goods and services that enable it to stay in business. In the public sector, costing is a comparatively underdeveloped practice.

Clearly, in the private sector, an organisation needs to understand its cost profiles, drivers and behaviours if it is to set prices for its goods and services that enable it to stay in business. In the public sector, costing is a comparatively underdeveloped practice. However, the current focus on securing greater efficiencies and value for money, and specific policy initiatives, such as activity-based costing in police authorities and payment by results in the NHS, mean that top management will need to pay increasingly greater attention to costing and project appraisal techniques in order to provide decision makers with better information.

- 76 CIMA has noted that ‘successful strategies...are the end product of a structured and disciplined decision-making process’<sup>I</sup>.
- 77 For an organisation to be successful, strategic and operational plans need to be based on an understanding of the financial implications of allocating resources to different activities. This requires an organisation to:
- understand its cost profiles; and
  - have robust investment appraisal and project management processes.

## Cost profiles

- 78 For an organisation to be able to operate successfully, it must understand what costs it incurs and how they change. Information must be fit for purpose and be provided on a timely basis. The data provided must be as accurate as possible. CIPFA notes that ‘knowledge of costs and cost behaviour is an essential ingredient for effective decision making’<sup>II</sup>.

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I CIMA, *Maximising Shareholder Value: Achieving Clarity in Decision-Making*, 2004.

II CIPFA, *A Question of Cost – How Costs Behave and How to Control Them: A Practical Guide for All Managers*, 1995.

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## Case study 6

At Reuters, around 100 business analysts have been trained in using an activity based costing (ABC) tool. The tool looks at how resource costs (for example, salaries, utilities and rental), are consumed by work activities, which are components of various end-to-end processes in an organisation. The activities and processes are driven by the products provided to customers and accordingly can be linked at this level, providing more accurate measures of profitability.

Reuters have used the ABC tool to obtain a detailed analysis of profitability by division, geography and customer. This information is also being used to support the strategic planning and budgeting process and business decision making.

*Source: PricewaterhouseCoopers*

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- 79 Organisations need a rigorous process to build up and analyse cost information across the range of services they provide. This should include an analysis of the cost drivers for each service, considering, for example, if costs increase in line with activity, if they are stepped costs or if they are relatively fixed overhead costs. There should be a clear understanding of what factors influence an organisation's costs. This analysis should be used to understand how cost profiles have changed and what the drivers for this have been. Only once these factors are understood can an organisation understand the financial impact of strategic and operational plans. CIPFA has pointed out that 'if cost information is to be of any use, we have to understand how costs arise, why they change and if they can be either influenced or controlled'<sup>1</sup>.
- 80 Cost analysis should not be a one-off exercise. Costs should be analysed at regular intervals, as they will be subject to change. Managers should be kept up to date as to the nature of the costs they are incurring, how they are expected to change over time and how they can be influenced and controlled. This should include an analysis of variances that have arisen to understand why costs have differed from those budgeted and how this can be addressed. Budgets may also require updating as costs change. Areas of high cost should be identified, scrutinised and reviewed on a regular basis to ensure that the organisation is achieving value for money. Summarised cost information should be presented to the board or equivalent on a regular basis.

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<sup>1</sup> CIPFA, *A Question of Cost – How Costs Behave and How to Control Them: A Practical Guide for All Managers*, 1995.

- 81 A wide range of different costing methods can be used in different circumstances and for different purposes. Each organisation must ensure that the costing methods it uses are the most suitable for its particular business and activities.
- 82 Costing information is particularly relevant when setting the price for a particular service, and an organisation will need to understand the implications of any pricing policy before deciding upon it. It may be acceptable for a particular service to recover only direct costs, whereas in other cases it may also seek to recover indirect costs and overheads. However, this must be an informed strategic decision made by top management, not a decision made due to a lack of available and relevant information. For services where pricing is not applicable, for example, where the service is funded by grants or other income, a review of the costs of the service and how these are matched by income should still be carried out and should inform policy decisions.

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### Case study 7

Continental Airlines Inc, a major US airline, has developed advanced IT and financial reporting systems.

Previously, the limited reporting system pooled together all revenues and costs per route, per month, and therefore provided little understanding of where the company was making money. Continental could not even identify the number of passengers per flight or how much those passengers had paid for their tickets. Furthermore, there was no way to construct forecasts with any degree of sophistication.

To get a better idea of costs and revenues, Continental developed a Flight Profitability System (FPS), which used a data warehouse and a sub-series of data stores to help uncover individual flight performance. For example, the airline discovered that on Christmas Eve, two flights were scheduled from Houston to London within a four-hour time period, both with only 30 passengers. This data would previously have been included in the monthly totals, making it impossible to identify which flights were profitable.

The new web-based system allows Continental to access data from various operating systems, allowing managers to consider costs such as fuel, catering and airport fees. This enables accurate costing of individual flights. The reporting system also allows managers to build 'what if' calculations that accurately forecast revenues and cashflow for a number of scenarios.

*Source: PricewaterhouseCoopers*

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- 83 Organisations should also benchmark their costs wherever possible to ensure that they are securing value for money. This can be incorporated into regular monitoring reports, or can be carried out through a rolling programme of larger-scale benchmarking. All organisations should consider carrying out a programme of benchmarking, looking at key inputs and outputs and comparing them both internally and externally. The ICAEW has described benchmarking as ‘an ongoing learning experience that emphasises the discovery of best practices and the adaptation of these practices for superior performance. Ultimately, it reflects an attitude that is driven by customer requirements and competition to strive constantly for excellence’<sup>1</sup>.

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### Case study 8

Xerox Corporation, best known for its photocopiers, also makes and sells printers, digital presses and multifunction devices. While Xerox measures performance in about 240 areas, benchmarking has now become an everyday activity for all departments. Top management shows commitment to benchmarking by:

- assigning benchmarking managers to departments;
- allocating resources to ongoing benchmarking training; and
- communicating benchmarking initiatives and results frequently and company-wide.

Xerox defines all of its work in terms of 14 high-level processes, all of which include many sub-processes. The company prioritises benchmarking projects according to what will have the most significant impact overall on company strategies. For instance, when Xerox’s goal was to improve logistics processes, it prioritised benchmarking those processes that would help the company meet its three primary objectives: increasing inventory turns, increasing service levels and decreasing logistics costs.

To uncover world class logistics management practices, the benchmarking team compared selected processes to those of other companies identified as quality leaders in integrated supply chain management.

**Source:** *PricewaterhouseCoopers*

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<sup>1</sup> Faculty of Finance and Management, ICAEW, *Implementing Benchmarking*, 2003.

## Investment appraisal and project management

- 84 Strategic and operational decisions must be based on a proper and thorough assessment of the financial and wider business implications. This includes an understanding of the benefits that can be expected from allocating resources to certain projects or activities.
- 85 All new investments, whether capital or revenue, should be subject to a robust investment appraisal process, which evaluates their relative costs and benefits, both financial and non-financial. This assessment should consider the financial impact on all the primary financial statements over a medium- to longer-term period. This should include any capital spend, income generation, projected overall cost savings, additional costs and cashflow impact. For example, a capital investment project will need a thorough assessment of the whole life costs associated with it and the impact on income and expenditure and cashflow as well as the balance sheet.
- 86 Finance staff need to liaise with colleagues from outside the finance department and possibly outside the organisation to gain an understanding of the financial impact of particular projects. The information on which the appraisal is based needs to be sufficiently robust to provide a sound basis for the decision-making process.
- 87 Investment appraisal involves not only analysing the proposed project, but also a thorough assessment of other potential policies, programmes or activities. The results of the appraisal (including potential options) should be presented to the board, or its equivalent, clearly and objectively to allow it to make an informed decision based on the facts. As CIMA has commented, ‘the choices presented have to be considered and realistic, not chosen for their ability to make the preferred option look better’<sup>1</sup>.
- 88 Investment appraisal should also include a sensitivity analysis, considering what the risks are to the project, the likelihood of these risks crystallising and the controls that need to be put in place to mitigate the risks. Different financial scenarios should be considered and presented to top management to demonstrate the range of possible outcomes and to allow risk management strategies to be approved. Good investment appraisals, linked to a clear business case, will support decision making throughout the project.

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<sup>1</sup> CIMA, *Maximising Shareholder Value: Achieving Clarity in Decision-Making*, 2004.

- 89 Following investment appraisal and a new project or strategy being approved, the new project should be monitored. The board, or equivalent, should develop and agree key indicators to ensure that the project is on track and that expected benefits have been realised. Where projects do not progress according to the original plan, action should be taken in line with the mitigating strategies developed as part of the project appraisal process. For major new projects or service developments, the board or its equivalent may wish to set up a sub-committee to monitor the implementation of the plan.
- 90 Following completion of a major project, a post-project review should be carried out to identify any lessons to be learnt from the process. This should consider what benefits were realised from the project and whether or not these were the benefits that were anticipated. This should also include an assessment of whether the planned value for money was achieved.

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### Case study 9

ITT Automotive is one of the world's largest suppliers of automotive parts and systems. In order to control costs and remain competitive, the company has appointed a permanent costing group to analyse each bid that it prepares for customers. The group includes representatives from engineering, cost accounting (finance) and sales.

The group considers whether the product fits ITT's strategic goals and whether the customer's required volume can be produced. This analysis includes a consideration of ITT's internal rate of return and return on investment to ensure the optimum return on each product.

After calculating a product's target cost, the costing group assigns specific targets to final assemblies, sub-assemblies, individual components and labour. Target costs are tracked through a product's life cycle, from design through to production. This process ends only when the product is discontinued.

*Source: PricewaterhouseCoopers*

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# 4



## Financial monitoring and forecasting

Having set its financial plans for the year, an organisation needs to monitor its performance against them. Budget monitoring is about more than just delivering the planned bottom line figure at the end of the year. It is about delivering against each of the constituent elements of the budget.

Having set its financial plans for the year, an organisation needs to monitor its performance against them.

Budget monitoring is about more than just delivering the planned bottom line figure at the end of the year. It is about delivering against each of the constituent elements of the budget. Given that the financial resources reflected in the budget should reflect the organisation's commitments and priorities at the start of the financial year, any unplanned departure from the budget has significant implications. So monitoring performance against the budget and accurate forecasting of projected outturn, to ensure that resources are applied on the ground and any variances can be managed in accordance with corporate priorities, is critical to achieving organisational objectives.

In the public sector, top management too often does not focus on financial performance until well into the financial year, at which point it will forecast significant variances from the plan. This in turn prompts a period of fire fighting to bring spending back in line before achieving a bottom line outturn in line with the plan.

Good in-year monitoring and forecasting is also critical to timely closedown and production of annual accounts, thereby meeting the organisation's accountability to external stakeholders.

- 91 CIMA has noted that 'recent cases of corporate failure have underlined the importance of performance reporting – an area that many firms assume is simple but find hard to get right'<sup>1</sup>.
- 92 A financial monitoring and forecasting system enables the management of an organisation to consider its financial performance and forecast outturn for a given period, identifying variances and trends. This enables corrective action to be taken to manage unfavourable variances or for favourable variances to be applied to corporate priorities. Financial monitoring and forecasting reports should lead to prompt action to investigate variances from the plan and take corrective action as appropriate.

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<sup>1</sup> CIMA, *Performance Reporting to Boards: A Guide to Good Practice*, 2003.

- 93 An organisation's financial monitoring and forecasting system should:
- provide high-quality, accurate information on a timely basis;
  - cover appropriate financial and non-financial indicators; and
  - use integrated systems to record and produce information.

### Providing high-quality, accurate information on a timely basis

- 94 The information that is provided by any financial monitoring and forecasting system will be used to measure the financial health of the organisation. It will also form the basis of operational and strategic decisions in both the short and long term. It is therefore vital that this information is accurate, but it must also be produced as quickly as possible to enable management action to be taken where necessary. In practice, there may need to be a trade-off between these characteristics.
- 95 In world class organisations, financial monitoring and forecasting packs may be available to top management and the board, or its equivalent, as soon as three days after a period end. The production of these reporting packs in this timescale requires robust period-end procedures, including the capture of accruals-based information and recognition of any other financial commitments.

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### Case study 10

The finance department at Cisco Systems Inc has shortened its closedown period to three days and can call up accurate figures for key metrics with an hour's notice. This allows the company to seize opportunities or deal with problems at their earliest indication. For example, if sales soar overnight in South America, Cisco can analyse and exploit the situation immediately, not three or four weeks later. However, in practice it has taken eight years to create the electronic infrastructure and streamline the finance department to reach this position.

*Source: PricewaterhouseCoopers*

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- 96 Financial monitoring information will never be completely accurate due to the speed of production of the reports and the inherent uncertainties involved in estimating accruals. However, it is for each organisation to decide on what level of sensitivity is tolerable when considered against the need for timely reporting, what the monitoring information will be used for and the cost of preparing the information.

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### Case study 11

In Australia, the financial year end for public sector organisations is 30 June. Each year, the Australian Government publishes a Final Budget Outcome (FBO) report, which includes material financial statements of various public sector organisations. The timeframe for preparation and audit clearance of material financial statements used in the FBO is being shortened progressively, with a target date of 30 July in 2005 and 20 July in 2006.

In order to meet the deadlines, departments are having to improve their in-year financial monitoring. For example, the Department of Communications, Information Technology and the Arts distributes full accrual monthly financial reports within one day of the end of each month to senior managers. Following an analysis of these reports, a full set of financial management reports, including commentary, is prepared within 13 days of the end of the month.

*Source: Audit Commission*

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- 97 Good-quality forecast information should also be included within reporting packs. Trends should be analysed and extrapolated to demonstrate their impact, but forecasts should not just be based on historical data. Organisations need to be realistic about their future pressures and opportunities and incorporate these into forecasts of income, expenditure, cashflow and working capital. These in turn should be subject to risk and sensitivity analysis.

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### Case study 12

The Children's Hospital of the King's Daughters based in Norfolk, Virginia uses a program designed by SRC Software to update the hospital's annual budget plan based on different scenarios. For example, if the hospital's fixed budget is calculated based on 20 patient days in the hospital, but the actual count rises to 25 patient days, Children's Hospital can run the software program to find out the overall impact on the

budget, from the potential increase in staffing, to lab work and medication costs. The ability to analyse different budget scenarios enables more time to be focused on strategic financial decisions.

*Source: PricewaterhouseCoopers*

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- 98 Reports should also include basic variance analysis and cost analysis (for example, unit costs or activity costs). Selected exception reports are also a useful tool for financial monitoring.

### **Integrating financial and non-financial indicators**

- 99 World class organisations integrate both financial and non-financial indicators to measure performance. They also keep it simple by using a limited set of performance metrics within each business process. These should be set by management and should be aligned to the strategic objectives of the organisation. The idea is to weed out the least important measures – experience suggests that 20 per cent of the measures provide 80 per cent of the useful information.

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### **Case study 13**

**Toyota Motor Corporation uses only three metrics per process – cost, quality and delivery, or what the company calls the QCD trio.**

*Source: PricewaterhouseCoopers*

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- 100 The indicators used should be balanced, in order to reflect the different dimensions of the organisation's business. They should look both internally, to measure different aspects of financial and non-financial performance, and externally, to consider stakeholders and comparative organisations to ensure that their priorities are being addressed and that they remain satisfied. CIPFA adds that indicators should 'provide adequate information about the value for money achieved by the key functions of the organisation'<sup>1</sup>.
- 101 Reported indicators should be reviewed periodically to ensure that they remain relevant and provide the best way to monitor the overall performance of the organisation.

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<sup>1</sup> CIPFA, *Management Information: Can You Manage Without It?*, 1997.

## Integrating systems to record and produce information

- 102** A world class organisation will have an integrated approach to collecting and producing performance data, both financial and non-financial. In practice, this means that there will be a limited number of systems that interface with each other and that the same system producing historical data can also be used to provide forecasts and budget updates.

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### Case study 14

General Electric Company (GEC) makes reporting dashboards a standard feature for thousands of its managers worldwide. These integrate customised key performance indicators (KPIs) in a visual format and provide the ability to drill down into deeper information to facilitate strategic analysis, decision making and corrective action.

GEC defines its company-wide KPIs into three distinct categories: internal productivity, external sourcing and customer work flow. Each GE manager has a dashboard displaying 10 to 15 real-time KPIs that represent more detailed sub-levels of all three categories, such as sales status, daily order rates, finished goods inventory or conversion costs. Additionally, all the dashboards have automated alerts, drill-down analytical capabilities and the ability to compare with external metrics. These dashboards allow GE managers to quickly assimilate performance and rapidly adjust operations, keeping results in line with strategic plans and company goals.

*Source: PricewaterhouseCoopers*

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- 103** The systems used need to link across all the primary financial statements, covering income and expenditure account, balance sheet and cashflow/treasury management. This will help to prevent any errors or omissions in reporting. It will also reduce the amount of work required by the finance department to reconcile the different statements or to make manual adjustments. Non-financial information should be used as a basis for financial forecasts.
- 104** World class organisations allow budgetholders to access monitoring and forecasting information on the system or organisation's intranet (rather than waiting for paper print outs). This allows quicker analysis and response to performance information and should include the ability to drill down below the headline figures to the underlying data. The system should also be flexible enough to enable specialist reports to be designed where applicable and to be accessed at any time (not just period end) to give access to real-time information.

- 105 The financial system needs to be robust and reliable so that it is available when required and does not suffer from regular breakdowns or technical defects. The system should be tested and backed up regularly and subject to full business continuity procedures.
- 106 Finally, it is critical that internal and external reporting systems and processes are fully integrated. The system that produces the internal monitoring information should also be used to produce year-end statutory accounts and other external reporting information. Management should be able to see a clear trail between results reported internally during the financial year and those reported externally to stakeholders at year end, providing consistency of reporting. As CIMA notes, there should be ‘one single truth with one set of robust, real-time (or near real-time), integrated information, supplemented with analytics that are both rigorous and consistent in approach’<sup>1</sup>.

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<sup>1</sup> CIMA, *Improving Decision Making in Your Organisation: The CIMA Strategic Enterprise Management (SEM) Initiative*, 2003.

# 5



## Financial reporting

In the public sector, the production of end of year accounts is still seen as a one-off exercise, whereas in the private sector the final accounts are simply the normal month 12 management accounts with some final year-end adjustments. In the public sector, the final accounts may often be the first occasion on which income and expenditure is properly accrued and a balance sheet is prepared.

**In the public sector, the production of end of year accounts is still seen as a one-off exercise, whereas in the private sector the final accounts are simply the normal month 12 management accounts with some final year-end adjustments. In the public sector, the final accounts may often be the first occasion on which income and expenditure is properly accrued and a balance sheet is prepared.**

**Timely reporting to stakeholders is a pre-condition of proper accountability. If public bodies are to achieve earlier year-end closure and publication of their annual accounts, they need to re-engineer their accounts production processes and their in-year monitoring and forecasting processes. Using the same set of financial information for both internal and external reporting purposes ensures consistency and enhances the quality of reporting to both internal and external decision makers.**

**107** The basic principles of performance reporting apply to reports produced for the highest level of monitoring (monthly board level) or for lower down the organisation (weekly or fortnightly for individual budgetholders), and to both internal and external reporting.

**108** Financial reporting (both internal and external) must be:

- tailored to the needs of the user or stakeholder;
- presented on a timely basis; and
- open, clear and concise.

### **Tailored to the needs of the user or stakeholder**

**109** Internal and external users of information will rely on a range of financial and non-financial information and indicators to support them in making their decisions. When producing information for use by these decision makers, it is therefore important that this information is properly tailored to the needs of its audience. Those who prepare reports need to consider carefully who the report is for and what its purpose is, including what decisions the user will be making based on the information they provide.

- 110** For internal reporting, the finance department should meet the recipients of reports and gain a full understanding of their requirements. This also allows the finance department to explain what information can reasonably be provided within the resources and timescales available. CIPFA has noted that ‘many organisations have failed to consider fully the information needs of the board and senior managers and so have not organised themselves to provide it’<sup>I</sup>.
- 111** In order to decide what information they require, the users will need to identify the key factors on which they base their decisions. These key factors will normally relate to income and expenditure, as well as balance sheet and cashflow items, but may include benchmarking information and cost behaviour information to enable them to interpret and compare the performance of the organisation. Reports should also flag up emerging risks and opportunities as they are identified, to allow action to be taken where appropriate.
- 112** Reports should include only that information that is required for a user to come to an informed decision. Too much information, or inclusion of irrelevant information, can be confusing and undermine the effectiveness of the decision-making process.
- 113** Information should only be provided for areas that are within the decision maker’s control and for which they are accountable. The financial performance of each individual area of the organisation should be included in at least one person’s objectives (usually the budgetholder), to ensure full and proper financial accountability of the organisation as a whole.
- 114** The board or equivalent should receive reports that cover the information they require to manage the strategic direction of the organisation. This should be linked directly to the organisation’s strategic objectives, and provide information to allow decisions to be made at the highest level. As CIMA points out, ‘the quality of performance reporting to boards is... one of the key factors affecting companies’ competitiveness’<sup>II</sup>.

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<sup>I</sup> CIPFA, *Management Information: Can You Manage Without It?*, 1997.

<sup>II</sup> CIMA, *Performance Reporting to Boards: A Guide to Good Practice*, 2003.

**115** Similarly, reports to external stakeholders must be tailored to their needs. Organisations should seek their views as to what information is required to ensure that any reporting is as useful as possible. Clearly, there are mandatory reporting requirements as to what must be included in financial statements and annual reports. However, the principles of good reporting still apply and each body should tailor any external reports so far as possible to the appropriate local or national audience.

**116** PwC has suggested that the principles of good-quality reporting include:

- better – not more – information;
- the links between the information provided and the company’s stated strategy;
- quantified data that support qualitative statements;
- metrics that, where relevant, illustrate performance against peers; and
- where appropriate, a statement of future ambitions<sup>1</sup>.

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### Case study 15

PricewaterhouseCoopers’ Building Public Trust Awards recognise the commitment of the UK’s leading public and private institutions to build transparency into their communications with key stakeholders.

More information on the criteria and winners is available on [www.bptawards.com](http://www.bptawards.com).

*Source: PricewaterhouseCoopers*

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**117** Information produced for both internal and external purposes should be derived from the core financial systems. The benefit of using one key system is that it ensures there is only one version of the truth and that decisions throughout the organisation are being made consistently on the basis of the same information.

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<sup>1</sup> PricewaterhouseCoopers LLP, *Building Public Trust Awards 2004 – Recognising Reporting Excellence*, 2004.

## Presented on a timely basis

- 118** For internal users to respond to any variances, information must be provided on a timely basis. This means that financial information should be produced as soon as possible following a period end. For decision makers, this may mean producing information on a daily, weekly or fortnightly basis, as well as for monthly senior management reporting packs. It will be for the decision maker, in consultation with the finance department, to decide on tolerable accuracy levels for the information, to ensure that it is not only timely, but accurate enough to support the necessary decision making.
- 119** Timely reporting is also important for external stakeholders. Some private sector companies are able to post their annual results within days of the financial year end. Currently, this is a target to which most UK public sector organisations can only aspire.
- 120** The ICAEW article, *What use is the 'fast close'?*<sup>1</sup>, notes that some US companies can post annual results just nine days after the end of their financial year. Although some of these results are unaudited, 'significant restatements are uncommon' and 'the vast majority of the best US companies are reporting quickly, fully and accurately'.
- 121** In Australia, the timetable for some public sector bodies to produce audited financial statements is significantly ahead of the UK. The financial year end for government bodies is 30 June, and the 2005 deadline for audited financial statements was 30 July 2005.
- 122** Speedier closedown at the end of the year also enables the lessons of the previous year to be quickly assimilated and ensures a firm basis for monitoring and planning in the following years.

## Open, clear and concise

- 123** Internal decision makers in any organisation will not normally have the financial analysis skills of finance professionals. The way that information is presented to decision makers is therefore a critical professional responsibility. Reports should be clear, relevant and concise so they can be quickly and easily assimilated and understood by the user.

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<sup>1</sup> David Jones, *What use is the 'fast close'?*, ICAEW Faculty of Finance and Management, March 2004.

- 124** In a world where increasingly sophisticated technology is available, the sheer volume of data that can be analysed, repackaged and produced is overwhelming. Reporting systems should be tailored to produce the information that is key to managing the business and that supports the critical decisions that need to be taken.
- 125** As well as receiving high-level information, management should be able to drill down where necessary to access more detail, should they decide that an issue highlighted in a summary financial monitoring report merits further attention and investigation.
- 126** Management reporting packs should not be overly long and should not include a large amount of detailed data. Instead, they should be short and concise. They should include all of the key financial and performance indicators that management needs to understand the business performance (for example, cost drivers, such as activity information).
- 127** The information should be provided in a format that allows the user to quickly identify the key messages. As CIPFA has pointed out, ‘the most accurate, up-to-date information can be poorly received if the presentation is unclear or confusing’<sup>1</sup>. These key messages can be emphasised through the use of graphs or diagrams, ideally supported by narrative explaining the critical issues. The information should also offer high-quality, easy-to-understand commentary and analysis, which aids the decision maker in appraising the options available. This advice should be objective, setting out the financial implications of the possible options, allowing the decision maker to make an informed choice.
- 128** The tone of the written element of the reports is also crucial. Reporting should be transparent, containing both good and bad news. Where the performance of an organisation is falling below that expected, those who can make decisions to rectify matters need to be told the facts plainly and objectively. There should be sufficient commentary to explain the financial performance without leading the user to a particular decision. Monitoring reports should also highlight any financial risks and the sensitivities relating to particular risks.

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<sup>1</sup> CIPFA, *Management Information: Can You Manage Without It?*, 1997.

- 129 For external stakeholders, information should also be presented in such a way that it is both relevant and useful to them. As PricewaterhouseCoopers has noted, ‘as the demand for greater transparency has increased, narrative reporting has emerged as one of the solutions of choice for improving corporate transparency’<sup>1</sup>. Organisations should consider what messages will be useful to external stakeholders and seek to communicate them clearly.

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### Case study 16

The City of Malmo in Sweden produces an annual report that includes a wide range of information for stakeholders. It contains an administration report that summarises national and local factors impacting on the city's financial performance, a personnel report, an education report, a report detailing performance against the City's objectives for the year, an environmental report and a welfare report, as well as the financial statements. This provides stakeholders with a clear and complete picture of how the City is performing across its activities.

*Source: PricewaterhouseCoopers*

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- 130 Top management needs to take collective responsibility for the organisation's published financial and non-financial information, particularly as an organisation's accounts are the means by which the organisation provides an account of its stewardship of resources and financial performance to its stakeholders. The annual report also forms part of this accountability, and this report to external stakeholders should provide an objective, balanced and understandable assessment of the organisation's activities and achievements and of its financial position and performance.

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<sup>1</sup> PricewaterhouseCoopers LLP, *Trends 2005: Good Practices in Corporate Reporting*, 2004.

# Conclusion

- 131** This discussion paper illustrates the standards of financial management that can, and have been, achieved in some organisations around the world. We hope that it will stimulate public bodies to challenge their current thinking around financial management and to broaden their approach. We believe it also sets out a conceptual framework within which we can develop our future work in this area.
- 132** But are these standards of performance appropriate for the public sector? If so, how could they be achieved? What improvements would be required? What are the main constraints to achieving them?
- 133** In recent annual reports on the Commission's audit regime, we have outlined key weaknesses in financial management in local government and the NHS. In particular we have highlighted:
- weak governance arrangements, in particular, the absence of effective challenge by audit committees;
  - a lack of corporate ownership of financial management arrangements, which have contributed, particularly in local government, to what we have described as a poor culture of financial reporting;
  - the need to re-engineer the accounts production process to meet the need for more timely reporting to stakeholders; and
  - the need for more effective approaches to in-year financial monitoring, reporting and forecasting.
- 134** Appointed auditors' local work has highlighted other issues, as reflected in several public interest reports on financial management issues. These include the need:
- for longer-term financial planning, which links to better service and financial planning so that budgets and longer-term plans better reflect corporate priorities;
  - for better, clearer reporting to top management, integrating financial and non-financial performance information and for top management to enable corrective action to be taken on a timely basis;
  - for better and more timely information for appraisals and decision making;

- to focus management attention more on the balance sheet and cashflow rather than just income and expenditure; and
- to understand the organisation's cost base better, what drives those costs and how they behave.

**135** All of these issues will be brought into sharper focus by the current challenges that local government and NHS bodies face, such as responding to the Gershon agenda and payment by results. Doing nothing to address these issues is not an option.

**136** The Commission – working with a range of partners – will continue to focus on the practical improvements that, in our view, need to be made to address these weaknesses and issues and to drive up standards of financial management generally in local government and the NHS.

**137** For example, we are working with CIPFA to develop guidance on audit committees, new approaches to financial monitoring and forecasting and balance sheet management.

**138** In the NHS we are working with our partners in the NHS Financial Management Advisory Group to develop a shared agenda on financial management and to consider the implications of the current change agenda on the future management skills and competencies that will be required in the NHS. We are also preparing a report on learning from recent well-publicised financial failures.

**139** In both local government and the NHS, the key lever available to the Commission to bring about improvements in financial management is the use of resources judgements. These are qualitative assessments of the effectiveness of different aspects of audited bodies' financial management arrangements, which auditors will be required to deliver for both the Commission's CPA and the Healthcare Commission's assessment model.

**140** In developing the key lines of enquiry and related criteria that underpin these judgements, we have been able to reflect the Commission's expectations about the minimum acceptable level of performance in different aspects of financial management, while at the same time describing the level of performance required if an audited body is to be judged as good or excellent. This will provide an incentive for audited bodies that aspire to a good or excellent rating to improve their arrangements and to address specific weaknesses and issues.

- 141 We hope you have found this discussion paper both interesting and useful. Our purpose in developing it is to stimulate debate within the profession and across public services about what achieving world class standards of financial management in government might mean in practice and, more broadly, what standards of financial management the public sector should aspire to over the longer term.
- 142 We would welcome comments on the ideas set out in this discussion paper and the potential implications of our research for financial management in local government and the NHS. To stimulate debate we invite commentators to address the following questions:

## General

- What are the priorities for improvement in financial management in the public sector and why?
- What are the main obstacles that need to be overcome if public sector bodies are to deliver these improvements?

## Specific

- Is there a need to improve financial literacy among non-executives and senior managers and to foster a greater sense of collective ownership of, and responsibility for, financial issues? If so,
  - what practical steps do public bodies and other stakeholders need to take to encourage such ownership?
- Is there a need to improve financial planning? If so,
  - which aspects need most improvement? and
  - what practical steps do public bodies and other stakeholders need to take to improve?
- Is there a need to improve financial forecasting? If so,
  - which aspects need most improvement? and
  - what practical steps do public bodies and other stakeholders need to take to improve?

- Is there a need to improve financial reporting to decision makers? If so,
  - which aspects need most improvement? and
  - what practical steps do public bodies and other stakeholders need to take to improve?
- Is there a need to provide more timely financial information to stakeholders? If so,
  - within what period should public bodies be expected to report in? and
  - what practical steps do public bodies and other stakeholders need to take to improve?
- Is there scope to use management accounting techniques (costing, investment appraisal) more effectively to improve financial and non-financial performance? If so,
  - which techniques would have most impact?
  - what practical steps do public bodies and other stakeholders need to take to make this happen?

143 Please send us your comments and contributions to [worldclassfm@audit-commission.gov.uk](mailto:worldclassfm@audit-commission.gov.uk).

## Acknowledgements

- 144 We are grateful to all those who have commented on this discussion paper and whose helpful views and suggestions have helped us to develop our thinking.
- 145 In particular, we are grateful to PricewaterhouseCoopers, the largest of our private sector audit partners, which has identified and selected the case studies that we have included in this discussion paper. Case studies 2 to 5, 7 to 10, and 12 to 14 were retrieved in April 2005 from PricewaterhouseCoopers' Global Best Practices® knowledge base.



- 146 Responsibility for the commentary in this discussion paper rests with the Commission alone.

## Suggested further reading

Audit Commission, *Achieving First-class Financial Management in the NHS*, 2004

Audit Commission, *Improving through Better Financial Management*, 2004

Audit Commission, *Getting the Groundwork Right: Financial Health for Local Authority Trading Units*, 2000

Audit Commission, *Planning to Succeed: Service and Financial Planning in Local Government*, 1999

Audit Commission, *Worth More Than Money: The Role of the Local Government Finance Director*, 1998

Audit Commission/CIPFA, *Regular as Clockwork: Raising the Standards of Local Government Financial Accounting*, 1993

Audit Commission/National Audit Office, *Financial Management in the NHS*, 2005

CIMA, *Maximising Shareholder Value: Achieving Clarity in Decision Making*, 2004

CIMA, *Improving Decision Making in Your Organisation: The CIMA Strategic Enterprise Management (SEM) Initiative*, 2003

CIMA, *Performance Reporting to Boards: A Guide to Good Practice*, 2003

CIMA/Faculty of Finance and Management, ICAEW, *Better Budgeting*, 2004

CIPFA, *Audit Committees – Practical Guidance for Local Authorities*, 2005

CIPFA, *Getting the Finances Right: A Briefing for Non-Executive Board Members of Public Service Organisations*, 2005

CIPFA, *Early Closing Time – A Good Practice Guide to the Prompt Closure of Local Authority Accounts in England and Wales*, 2004

CIPFA, *The CIPFA FM Model: Improving Financial Management and Effectiveness in the Public Service – Introducing the Model*, 2004

CIPFA, *Public Reporting and Accountability: A Good Practice Guide*, 2003

CIPFA, *What You Can Learn from ABC – Activity Based Costing and Activity Based Management in the Public Services*, 2001

CIPFA, *Achieving Excellence in Financial Management*, 1998

CIPFA, *Management Information: Can You Manage Without it?*, 1997

CIPFA, *Benchmarking to Improve Performance*, 1996

- CIPFA, *Making the Right Choices – A Practical Guide to Project Appraisal*, 1996
- CIPFA, *Managing Cash – A Practical Approach*, 1996
- CIPFA, *The Changing Role of Financial Management in the Public Services*, 1995
- CIPFA, *A Question of Cost – How Costs Behave and How to Control Them: A Practical Guide for All Managers*, 1995
- CIPFA In Scotland, *Audit Committee Principles in Local Authorities in Scotland*, 2004
- CIPFA/SOLACE, *Corporate Governance in Local Government: A Keystone for Community Governance (Framework and Guidance Note)*, 2001
- Faculty of Finance and Management, ICAEW, *Implementing Benchmarking*, ICAEW Good Practice Guideline, 2003
- PricewaterhouseCoopers LLP, *Building Public Trust Awards 2004: Recognising Reporting Excellence*, 2004
- PricewaterhouseCoopers LLP, *Trends 2005, Good Practices in Corporate Reporting*, 2004
- NAO, *Ready, Steady, Go... A Practical Guide to Preparing for Faster Closing*, 2004
- NAO, *Managing Resources to Deliver Better Public Services*, 2003
- Public Audit Forum, *The Whole Truth: Or Why Accruals Accounting Means Better Management*, 2002
- Tom Taylor, *NHS Financial Forecasting*, CIPFA, 2005
- Brian Singleton-Green, *New Reporting Models: The Challenge for Business*, Faculty of Finance and Management, ICAEW, 2004
- John Fanning, *21st Century Budgeting*, Faculty of Finance and Management, ICAEW, 2000
- Judith Shackleton, *The Future of the Finance Function*, Faculty of Finance and Management, ICAEW, 1998
- David Jones, *What use is the 'fast close'?*, Faculty of Finance and Management, ICAEW, March 2004
- Graham Harvey, *The Role of the Finance Function post Enron*, Faculty of Finance and Management, ICAEW, May 2003
- See also the Audit Commission's website at [www.audit-commission.gov.uk](http://www.audit-commission.gov.uk).







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