

# IFRS and beyond

The Third CIPFA/ICAEW Public Sector Conference 2010



## Summary

**These are notes taken at the London conference held on 5 March 2010. A similar conference was held on 12 March 2010 in Leeds.**

### Chair's Opening Presentation

**Ken Beeton, Director, Financial Management and Reporting, HM Treasury**

Ken opened the event by making a positive comparison with the situation a year ago at the previous CIPFA/ICAEW IFRS conference. Although difficult issues remained, he was confident that most of central government and associated NDPB's would receive clear audit opinions on the 2009/10 restatement of balances.

In contrast, local government is now in the position faced by central government a year ago. For example, the Audit Commission survey, *Countdown to IFRS*, highlights the absence of project plans and impact assessments. Among the key technical issues faced by local government were those of leases, plant and equipment and employee benefits. PFI/Service concessions were already a live issue for local government in the 2009/10 SORP. Delegates had an opportunity to consider these technical issues later in the day.

Given this situation, the principal theme of the conference would be to scope out the lessons learnt so far so that they could be shared with local government.

### Whole of Government Accounts and Alignment

**Karen Sanderson, Team Leader Government Estimates, Accounts and Reporting, HM Treasury**

Karen first sought to set the WGA and Alignment Project within the context of the Treasury's financial management objectives. Together they offered the prospect of more transparency and better fiscal decision making as financial data would be prepared using widely recognised accounting standards. WGA will, for example, incorporate provisions that are currently omitted in the ONS data.

The alignment project, she explained, would simplify Parliamentary business by reducing the number of financial documents. It would also provide better incentives for departments by reducing the number of control totals. She confirmed that WGA would be published for 2009-10 – the legislation just having been laid. It would be mirrored in the devolved administrations.

Karen drew attention to the scale of the consolidation exercise that incorporates 1,200 bodies. Guidance had just been issued on the key issues for 2009/10 and data collection packs would be sent out in April once they had been tested. Training would be provided in May. There would be mapping changes owing to the move from GAAP to IFRS in 2009/10

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The role of the auditors would be changing. Hitherto they had been reviewing rather than auditing the WGA. It would now be necessary to embed an audit process into the year end timetable. Karen stressed the benefits for both the preparer and auditor of integrating WGA with the statutory accounts – only the counter party information was unique to the WGA. Early thought about the sources of counter party information was as a consequence critical.

The information provided in 2008/09 was a marked improvement over that for the previous year. Nonetheless, failing to meet the timetable was still an endemic problem. This was especially the case as HM Treasury could not do the final consolidation until ALL the returns had been submitted.

Despite the improvement, data quality issues remained - even when using a +/- £50 million tolerance limit. The scope of the project also needed to be clarified, since the ONS definition of bodies “public in nature or wholly funded by the public purse” was not always clear cut. There would continue to be a discrepancy between the Highways Agency and Local Authority treatment of infrastructure assets – one that would not be resolved until 2012/13.

Turning to the Alignment Project, Karen stressed the strong support offered by Parliament. As a result it was accepting the loss of parliamentary control over income in pursuit of the greater prize of greater clarity. The source of the present confusion was self-evident from the current differences in the figures presented in the estimates, budgets and resource accounts. Not only would the new arrangements bring greater clarity, but also the opportunity for more cost-effective integrated systems and better scrutiny focused on only three Parliamentary publications each year. Some legislation remained outstanding before all the inter-dependencies had been clarified and resolved.

Karen explained that the alignment project brought more entities into the departmental boundaries than had the WGA. Entities that were too small to be material for the WGA will need to be picked up and consolidated by departments (not HMT) in the alignment project.

In summing up the opening presentation the Chair thanked Karen for stressing that WGA and the alignment project offered clear benefits and should therefore be implemented in the spirit of added value rather than simply compliance.

In answering a range of questions from delegates, Karen provided further clarification of the treatment of counter-parties and of the tests necessary to determine whether a SPV should be included. She also explained that Parliament had the appetite to embrace other private sector practices, such as mid-year closing, but that there remained practicalities to address. Finally she acknowledged that, while the WGA presentation would have the “feel” of a set of corporate accounts, it remained necessary to educate the financial institutions and other stakeholders so that they interpreted them correctly.

### **Lessons Learnt: What Worked, what didn't, technical issues – an NHS Case Study**

**Chris Wobschall, Head, Assurance and Financial Reporting HM Treasury**

Chris opened his presentation by explaining that he was excluding the Foundation Trusts from this case study and he stressed with some 300 bodies in the extended Department of Health

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“family” it was a challenge to communicate the IFRS agenda to all those who needed to know – not only in finance but also in HR and valuation.

A key strategic decision made by the NHS was to pursue their project to achieve early closing even though it became decoupled from IFRS implementation when the later was delayed. Another key decision was to involve the auditors at an early stage. Finally, part closing after 9 months did much to achieve faster year-end closing – and offered a model for IFRS implementation.

Faster closing was achieved in 2008/09, with only five NHS organisations (all trusts) missing the submission deadline for draft accounts – but the accounts were still laid before Parliament prior to recess. This set up the NHS well for IFRS implementation.

The lessons learnt included the need to appreciate the benefits and not treat it as a technical exercise. In addition a whole organisation approach was essential – from the Board through to the relevant non financial specialists on which success depended and beyond to other stakeholders in audit committees and external audit. Organisation wide project plans and a Project Board were a pre-requisite.

Intelligence on NHS preparedness for IFRS was provided by both Audit Commission IFRS Arrangement Reviews and NHS Readiness Reviews. The Audit Commission RAG assessment in the Spring and Summer of 2009 placed only 3 NHS bodies in the Red category – with the majority in Green. Particular pieces of good practice of particular pertinence to IFRS were the engagement with Audit Committees and the formal adoption of IFRS accounting policies.

There were, however, equally some concerns common to all those organisations at risk of failing to implement IFRS successfully. First among these was a failure to explicitly adopt or agree IFRS accounting policies and an inability to meet the more demanding IFRS disclosure information – especially with respect to leases and non-current assets held for sale. Second, LIFT/PFI schemes still represented a technical challenge. Thirdly, the need to reconcile UK GAAP reporting to IFRS could be problematic – especially as the difficulties were often a consequence of flaws in reporting under GAAP.

Chris stressed that the NHS Readiness reviews has the merit of demanding yes/no answers and therefore being amenable to aggregation to obtain a national picture of the risks. They also provided a useful checklist for organisations and a means to track progress over time. Behind the positive headline figures these revealed some striking results. Although in the summer of 2008, 22% of organisations had not done a IFRS impact assessment, only 1% of them did not think that their procedures were IFRS compliant. Equally, at this time 37% of organisations had engaged with their external auditors.

These measures ensured that only a relatively few PCTs (34) and NHS Trusts (4) received modified opinions the re-statements of 2008/09 balances. Nonetheless the most common issue behind these opinions was one which, despite the planning and risk assessments, emerged unexpectedly during IFRS preparation work. This was the question of whether the taking of a legal charge over a property as a condition of a grant brought it onto the trust balance sheet. While in practice few of these arrangements were brought on balance sheet, it remained necessary for each scheme (or a sample) to be assessed.

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Another issue that IFRS in the NHS has raised is the approach to segmental reporting. Chris argued that the critical test for its applicability was the manner in which the business was managed.

Looking to the future, the 9% of NHS organisations who had not revised their systems for IFRS would have to continue with resource intensive and ad hoc arrangements. More starkly, all NHS organisations claimed to be confident of meeting the accounts deadline, although 13% did not have the timetable necessary to demonstrate that this was the case. The ingredients for success are the need for such a project plan, the necessity of not underestimating the task and of not treating it as a narrow technical exercise for accountants alone.

### Accounting for Partnerships and Joint Financing Arrangements

Mark Williams, Associate Partner, Public Sector Advisory, Deloitte

Mark identified the theme of his presentation to be the essentially evolutionary nature of the changes brought in by IFRS. For most transactions it had not generated massive changes, but it has stimulated a valuable review of accounting policies and a critical appraisal of documentation. It moved finance to the centre of organisations and in doing so offered a platform for future influence.

Nonetheless, for partnerships and joint financing arrangements IFRS had posed a real challenge – principally in moving the fundamental test from one of risk/reward to one of control. . Given the potentially far reaching scope of government control, these were difficult issues to decide.

Ultimately the on/off balance sheet question would have to be determined according to the nature of the entity and the scope of the contractual arrangements. It was important to recognise that this was an accounting issue about reporting transactions and not one that should necessarily have “real world” implications. Above all, however, all future joint arrangements should be appraised at an early stage in order to ensure that the financial/budgetary implications are acceptable.

In practice, the issue of whether a scheme should be brought on balance sheet was often clear cut. Mark argued that most PFI schemes would be coming on balance sheet. The greater challenge was to decide on the appropriate valuation. Mark stressed the importance of utilising private sector financial models as an important source of data for understanding the counter party. Often an insight into the private sector perspective could be extremely valuable, but too often overlooked. For PFI schemes such models should be available as they may have been necessary to obtain the support of banks and other funders.

Mark made some observations on the implications of IFRIC 12 and flagged up the need for local government to pick up the lessons of the NHS experience of LIFT arrangements where control is indicated as a result of giving the Trust a first-call on the asset at the end of the arrangements. Equally, it is possible that grants to RSLs in return for nomination rights may create a parallel to the legal charge issue. He also highlighted that user-pay schemes may be on-balance sheet if the public sector body is responsible for controlling requirements.

Mark argued that while IFRS experience was useful in a project team, sound technical knowledge and top management “buy in” were essential. The ideal was for other specialists, such as HR and valuers, to engage with the finance agenda and for finance to manage the

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process. But in practice the fall back option was that finance has to develop its expertise so that it can engage constructively with these other disciplines. Where consultants are employed to, for example, review leases then knowledge of how this was done needs to be transferred to the client so that in the future this technical assessment can be done without external support. Above all, the mind-set developed during the IFRS process needs to be sustained into the future so that it can inform, but not dictate, the decision making process.

### **Launch of the Certificate in International Public Sector Financial Reporting**

**Michael Izza, Chief Executive ICAEW and Steve Freer, Chief Executive CIPFA**

The Chief Executives joined the conference to launch the most significant product of the strategic partnership between their two institutes.

Steve Freer explained that this certificate sought to address two special characteristics of financial reporting in the public sector. Firstly, the international context that has given to two international standards based approaches in the public sector: modified IFRS and IPSAs. Even in the UK, where the IFRS had primacy, the IPSAs were the reserve source of guidance if further clarification was needed. Secondly, there were transactions, such as the exercise of the right to tax, heritage assets or the recent bank “bail outs” that were peculiar to the public sector.

Michael Izza explained that the new certificate built on the ICAEW's experience of online training and its unparalleled knowledge of IFRS implementation in Europe. He explained the online assessment process and explained that the award would be recognised by both institutes.

### **Afternoon Workshop Sessions included:**

#### **Local Government IFRS challenges led by**

**Chair: Steve Warren, Head of Professional Standards, Audit Commission**

**Paul Mason, Technical Manager, Local Government Accounting, CIPFA**

#### **Financial management and managing the business led by**

**Chair: Andrew Baigent, Director General, Financial Audit, National Audit Office**

**Nick Jackson, Head of Finance Professionalism, HM Treasury**

**Keith Luck, Finance Director, Foreign and Commonwealth Office**

#### **Future reporting challenges (arising from IASB and IPSASB) led by**

**Chair: Ian Carruthers, International Public Sector Accounting Standards Board Member**

**David Loweth, Technical Director, Accounting Standards Board**

#### **Embedding IFRS from 2010 led by**

**Chair: Christina Earls, Review Manager, Department for Works and Pensions**

**Elizabeth Dobson, Specialist Group Accountant, Department for Transport**

**Andrew Baigent, Director General, Financial Audit, National Audit Office**

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### Summary and next steps

Ken Beeton, Director, Financial Management and Reporting, HM Treasury

The Chair summarised the day as providing a solid overview of the technical issues while at the same time energising the management response necessary for success.

If local government is to take away key messages from the experience elsewhere, then it is the need to do an impact assessment and to engage with audit committees and auditors. The NAO had been a valuable partner in the implementation of IFRS in central government so local government should see the Audit Commission as similarly acting as a critical friend.

In central government, WGA and the Alignment Project needed to be sold to non-finance colleagues as means to promote better scrutiny, clearer accountability and the removal of perverse incentives. Sound financial reporting was now moving into terrain previously occupied by economists and the national accounts. The result should be more transparent fiscal decision making.

All these changes offered finance professionals an opportunity to occupy the centre stage, but to achieve this they needed to maintain their skills and promote a culture that positively promotes best practice.

Attached as an appendix are articles from some of the sessions and workshops.

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## APPENDIX

### EMBEDDING IFRS

Christina Earls, Review Manager at the Department for Works and Pensions, and Elizabeth Dobson, Specialist Group Accountant at the Department for Transport, explain the dangers of regarding IFRS as just a technical accounting issue.

Central Government has now completed the first financial year (to 31 March 2010) for which the outturn will be assessed against IFRS numbers. Consequently, now is the best time to move IFRS reporting from the implementation stage to 'business as usual' activity, changing the focus from the immediate to the longer-term.

Although perhaps still preoccupied with making sure we have done everything correctly, we are presented with a great opportunity to consider what process improvements we can begin incorporating into regular activity. Too many practitioners and senior stakeholders still regard IFRS as purely a technical accounting issue, one which can be dealt with through greater overtime, or by external advisors, with detailed calculations undertaken largely off-system. This mindset needs to change. This can be best achieved by firmly embedding without delay a new way of working and thinking.

Reflecting on lessons learned in implementing the new IFRS way of working provides the starting point for identifying necessary process improvements. There are recurrent problems that auditors will always highlight, such as insufficient evidence to back up the accounting numbers. So ensuring that a good audit trail is factored into plans is essential. But the many other potential pitfalls identified include a lack of executive sponsorship, failing to agree major accounting policies (eg, for PFI), ambiguity over internal responsibilities (such as which activities shared services operational units should undertake), insufficient resource, lack of planning in determining the timetable, underestimating the complexities, and allowing other 'business as usual' distractions to take precedence.

To embed new ways of working following the transition to IFRS reporting, it is necessary to examine people issues, systems and processes, as well as ensuring that all technical accounting issues have been resolved.

#### People

If external advisors were used during the transition to IFRS, it is vital to ensure a complete transfer of knowledge; this is also desirable for succession planning to future-proof ongoing activity. Those same staff who were involved in implementing IFRS will not always be there, and skills-transfer needs to also occur internally, and not just within the finance fraternity either. Training should focus on key areas, and bring together IT and procurement colleagues with finance to ensure that the strategic and business risk implications of decisions are understood, for consideration with senior stakeholders.

#### Systems

If transition required a substantial amount of manual intervention, it may be advisable to question how the systems can be upgraded to take the strain, for example accrual calculations for annual leave or coping with newly-capitalised finance lease assets, always recognising the need for adequate audit trails.

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### Processes

It is vital to ensure that processes have been revised to ensure that contracts (especially new ones) are reviewed for embedded derivatives, leases and intangible assets. It is also important to review the close-down timetable to take account of all additional activity and the extra time needed in relation to particular accounting areas.

### Accounting

Assurance is required that everyone is familiar with the implications of IFRS requirements for financial instruments, including embedded derivatives - a new terminology for many, alongside many others emerging from the new accounting framework. It is also necessary to ensure that a full and systematic review of contracts is undertaken early on to ensure that everyone understands why leases have been classified as operating or finance leases. Guidance on revised capitalisation policies, covering all potential spend, needs to be cascaded to all businesses so they appreciate the implications for the accounts and what additional data is required.

Other key lessons learned from the transition to IFRS include valuing the involvement of the external auditors and retaining support at a senior level within the organisation. Auditors can provide useful guidance on robustness and effectiveness of process and systems for embedding purposes. Ongoing senior sponsorship remains essential, to ensure that the delivery of high quality and timely accounting to support decision support activity continues to be seen as a high priority.

Finally, it is essential to continue to improve understanding of IFRS principles and key requirements amongst other key areas of the business, for example:

- HR - holiday pay accruals;
- IT - systems changes;
- Procurement - contracts; and
- Others engaged in investment projects - capitalisation and assets.

These are still early days for IFRS reporting in the public sector. But the opportunity to embed the change in accounting regime and its significant business implications into 'business as usual', to maximise the benefit of the improved transparency in public sector financial reporting, is surely too good to miss.

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### HOW ESA 95 IS WORKING IN PRACTICE

Chris Hughes and Peter Dymoke, Senior Managers at PwC, look at some of the challenges involved in accounting for PFI in the UK public sector

The familiar landscape of PFI has changed in the last 12 months. Not only will Private Finance Initiative projects come on to the Balance Sheet (now the 'Statement of Financial Position') under IFRS principles, but the budgeting and accounting treatments could also diverge. As a result, provided they meet a set of given criteria, PFI projects could be excluded from the UK Government's calculation of Public Sector Net Borrowing (PSNB).

HM Treasury requires that PFI and similar projects ('service concessions') should be budgeted for according to their treatment in the National Accounts. This treatment follows the 'European System of Accounts 95' ('ESA 95'), the European Community rules that dictate how member states should prepare their national accounts to ensure consistency of preparation across the EC. In most cases, service concessions are recorded under ESA 95 according to the criteria set out in the Manual for Government Deficit and Debt, or the ESA 95 Supplement. Where a project falls within the category of 'services purchased by government on the basis of dedicated assets', the Supplement provides additional guidance on how to determine whether the Government has the risks and benefits of ownership of the assets underlying a project and therefore should account for those assets in its PSNB.

Essentially, if the operator takes the majority of construction risk along with the majority of either availability or demand risk, and if the risk transferred to the operator is significant, the assets will be excluded from the PSNB under ESA 95, and as a result will not score against capital budgets under the 2009/10 Consolidated Budgeting Guidance.

The determinants of accounting treatment under IFRIC 12 and ESA 95 (and specifically the ESA 95 Supplement) therefore differ. Treatment of assets within a contract is determined by the concept of 'control' in IFRIC 12 and on the 'balance of risk and reward' of ownership under ESA 95. Therefore, a project could be budgeted for differently to how it is accounted for under the two sets of standards. It is also possible for arrangements that are within the scope of IFRIC 12 to be without the scope of the ESA 95 Supplement, which can cause confusion, to say the least. For example, the ESA 95 Supplement does not consider assets such as toll bridges funded by payments from users. Nor does it consider projects where existing assets are refurbished and at a cost less than the existing asset value, for example adding a lane to an existing motorway.

### Comparison of experience of applying IFRIC 12 in Local Authorities and the NHS

As a result of recent amendments to the applicable Statement of Recommended Practice, local authorities currently apply IFRIC 12 principles in their 2009/10 accounts, bringing service concessions, including PFI schemes, on to their balance sheets prior to the formal introduction of IFRS in 2010/11. The NHS, like central government, has already had to submit audited restated 2008/09 accounts prepared under IFRS. Full IFRS requirements apply for 2009/10.

Practical application of IFRIC 12 principles has proved difficult in both sectors. In the NHS, some schemes that fell to be accounted for under IFRIC 12, but were not badged as PFIs, were not identified promptly. For example, schemes where Primary Care Trusts held legal charges over properties, from which they also controlled the services provided through certain commissioning arrangements, turned out to be, in many cases, on-balance sheet service concessions.

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A similar issue is occurring in many local authorities, where the identification and analysis of schemes that could fall to be accounted for as service concessions is still ongoing. Local authorities are considering schemes that involve the provision of vehicles to provide a service such as waste collection and home to school transport schemes, and contractual arrangements that involve nomination rights – for example social housing.

Local authority PFI schemes are also subject to different and often more complex payment structures, increasing further the challenges of practical application. There are many more types of scheme to consider, such as waste, street lighting, housing, leisure, information technology and building schools for the future. While the principles in the Local Government SORP Guidance Notes are relevant for all of the different types of scheme, local authorities are finding that accounting issues, such as the treatment of third party income in leisure schemes and the existence of Foundation Schools, do not have easy answers.

ESA 95 is particularly relevant to new local authority PFI schemes. The Department for Communities and Local Government requires that all PPP and PFI business cases submitted as part of an application for government grant support ('PFI credits') include an assessment of how the project may be classified in the National Accounts. Schemes will normally only receive PFI credits if they fall to be accounted for as off-PSNB under ESA 95.

As we face up to the new political and economic realities in the UK, PFI schemes in general, and the relationship between IFRIC 12 and ESA 95 in particular, are likely to remain topics at the heart of the debate about UK public sector financial reporting.

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### FINANCE IN AN AGE OF AUSTERITY

Mark Williams, Associate Partner in Public Sector Advisory at Deloitte, discusses the challenges faced by finance professionals in the UK public sector.

This article follows the theme of the Deloitte contribution to the 2010 'IFRS & Beyond' conferences hosted by the ICAEW and CIPFA in March 2010. It uses the example of complex accounting for partnerships and joint financing arrangements to highlight the unique challenges faced by senior finance professionals in the UK public sector. In an age of austerity, these challenges will increase, and finance professionals will become central to the decision-making process taking place in public bodies under the new Conservative/Liberal Democrat administration.

The regime for public sector accounting involves complexity that is, arguably, more testing than that of the private sector, and this adds strength to the argument that finance professionals need a greater level of visibility in public sector organisations. Expenditure budgets are normally fixed and outturns need to be achieved within tight tolerances (below budget, as well as over), particularly in the current economic climate. Under this budgetary regime there are a number of different types of spending. For example, capital and revenue expenditure are recorded separately, and there are limited opportunities to flex budgets, either in-year or between years. Budgetary affordability is, for the most part, determined by financial accounting, and since 1 April 2009, IFRS has provided the framework.

This budgetary regime means that the way affordability of programmes and projects, such as partnerships and joint financing arrangements, is considered in the public sector differs from the private sector. In the public sector, in addition to cash funding requirements and the total costs and the associated benefits (quantitative and qualitative), financial accounting can also be a key factor in achieving project approval.

#### Partnership and joint financing arrangements

Over recent years, with the aim of delivering public services more efficiently in a climate of declining departmental budgets, we have seen a greater number of - and more complex - partnership and joint financing arrangements.

In the case of partnerships, new entities and arrangements have been formed between both public sector bodies and between public and private sector in order to deliver back office functions, infrastructure and front line services. Joint financing arrangements include established private finance initiative (PFI) approaches, as well as more innovative public private partnerships and outsourcing models.

#### Change in accounting standards and budgeting

In addition to increased complexity and a climate of economic uncertainty, we have seen the rules applied in the public sector change.

Until recently, the accounting for these types of arrangements, including determining who should record any underlying assets and/or liabilities, has depended on an assessment of risk and reward. Under IFRS we have seen a shift to considering control. For example, under IFRS the guidance that applies to 'service concessions arrangements' is IFRIC 12, and this asks 'who has control?' The outcome of applying IFRIC 12 is that the majority of PFI, PPP and outsourcing arrangements now have to be recorded on the public sector's balance sheet for financial

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accounting. However, it is worth noting that the treatment in budgets of PFI and PPP contracts is one of the few exceptions where the budgetary and financial accounting treatments have been 'de-coupled', such that an on-balance sheet conclusion for financial accounting does not automatically lead to a call on capital budgets.

### Limiting finance's involvement

The following short case study highlights what can happen if the finance function of a public sector organisation is not central to the project appraisal process.

Deloitte became involved prior to the 'financial close' of a partnership funding vehicle arrangement. The business case involved external (non-governmental) funding in the form of loans being passed through an 'arms length' body onto third parties. However, after being asked to assess the IFRS accounting treatment, it became clear that our client retained control such that it was not an 'arms length' body and the funds flow would need to be included in our client's budget.

It was fortunate for the client's objectives that this was identified before any contracts had been signed, meaning that it was possible to renegotiate the terms so that the 'arms length body' was no longer deemed to be controlled by our client. Had this not been identified until after legally binding contracts had been entered into, our client would have faced un-manageable pressures on its budgets.

### Conclusion

Given the fiscal backdrop, it is important that UK public sector bodies explore new ways of delivering and financing their services. However, the additional complexity of partnership and joint financing arrangements, combined with the move to IFRS and reduced budgetary flexibility, means that an increased focus from senior finance professionals will be required. This also means that non-finance teams need to be familiar with the key affordability considerations, so they know when to involve finance colleagues in the project appraisal process.

As illustrated above, the risk of not involving finance colleagues, of not understanding the accounting implications, is potentially the failure of a major project – perhaps a risk too far in an age of austerity!

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### **FINANCIAL MANAGEMENT AT THE HEART OF PUBLIC SERVICE DELIVERY**

**Nick Jackson, Head of Finance Professionalism at HM Treasury, and Sumita Shah, Technical Manager with the ICAEW Audit and Assurance Faculty, discuss the importance of financial management in the public sector**

Strong financial management, integrated with performance management, is essential if government is to succeed in its policy-making, planning and delivery of key objectives. The finance function needs to move to the heart of this policy, delivery and decision-making role because its role isn't just to account for money after it has been spent; it needs to be closely involved right from the start of projects, before funds are committed.

With this in mind, at the recent CIPFA/ICAEW IFRS conference, there was discussion about the challenges for improving financial management within government, with the Foreign and Commonwealth Office providing highlights of its transformation (see article on page 15).

HM Treasury, working with the Government Finance Profession, advocates a top-down, cross-team approach, identifying overarching priorities to ensure that there is connectivity and that the focus is on the things that matter most. In the remainder of this article we summarise some of the key aspects of their approach: leadership and culture; integration; communication and engagement; standards and quality; and last but not least, professional qualifications and development.

#### **Leadership and culture**

Leadership and culture derive from a clear tone from the top, exemplified by the behaviours of senior management. Senior officials need to demonstrate and provide strong leadership and commitment to improving financial management within and across departments. Encouraging and influencing their peers and staff to behave consistently in accordance with good financial management and governance principles is a must.

#### **Integration**

Mechanisms need to be in place to facilitate, integrate and enable the implementation of effective governance and financial management throughout the organisation. It is important to embed the finance function into all aspects of decision-making, perhaps by linking achievement of finance targets to performance management.

Integration will provide a better basis for priorities to be set and will improve the visibility of costs against delivery of outputs and outcomes. It will also help to link inputs and activities to outputs and outcomes, and provides an evidence base for key decisions.

#### **Communication and engagement**

It is difficult to overstate the importance of two-way communication and engagement between leaders and staff at all levels, with clear lines for decision-making and accountability. Departments need to have an understanding, not only of their own role and activities, but also of the roles of others and how they can be supported effectively. Communicating the right information to the right people will enable the right decisions to be made.

It is also important to communicate and engage with relevant stakeholders. Providing clear and consistent messages will help to improve understanding of the financial management agenda. Departments should be open to challenge by stakeholders and indeed should respond to it.

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They need to fully understand the purpose of the service they are providing, know who the recipients are, why they need it and be open and responsive to stakeholder expectations.

### **Accounting standards and quality**

Financial reporting standards need to be applied appropriately in the context of the public sector to ensure that there is consistency and transparency. HM Treasury will provide guidance on definitions and application of requirements, but departments should then cascade that guidance down to all levels within the organisation. High quality systems and processes are needed to generate timely, high quality and relevant financial information for key decision makers to drive the performance of the organisation as a whole.

### **Professional qualifications and development**

It is highly desirable for staff responsible for finance within government departments to have a relevant professional qualification. This is now recognised within government and the number of qualified professionals is increasing. However, skills and competences need to be enhanced still further. To ensure that the right decisions are made to improve efficiency and effectiveness within the organisation, departments need to have the necessary skill-sets, competences, capabilities and commitment in place. They also need to recognise the need for professional development, and to identify and retain the right staff through managing their resources, succession planning and creation of appropriate opportunities for staff.

There are significant challenges involved in embedding and maintaining strong financial management throughout an organisation, but operating any other way is not an option. We believe that close and consistent attention by departments to the factors outlined above will ensure that steady progress is made towards that goal.

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### FIVE STAR FCO?

Keith Luck, Director General Finance at the UK Foreign and Commonwealth Office, explains the journey of the department from financial management straggler to 4\* and counting

'We do not often say this in this Committee: it is a good report . . . and you have made considerable progress.' *Committee of Public Accounts Chairman Edward Leigh to FCO Permanent Under Secretary Sir Peter Ricketts, October 2009.*

This quote from the hearing of the Committee of Public Accounts (PAC) on financial management in the Foreign and Commonwealth Office (FCO) will have turned a few finance directors' heads in Whitehall. The fearsome PAC praising a department traditionally a straggler in financial management? Edward Leigh's comment was based on a substantial National Audit Office (NAO) report, so this wasn't just the FCO talking a good game. What lay behind this transformation?

The FCO knew from several internal and external reviews that it was far from top of the class in managing its finances systematically and maturely. Its business was strategic policy, with some service delivery. With global dispersal and frequent moves amongst its UK staff, there had been little internal pressure to sharpen up its financial management. The top leadership recognised the need to improve resource management performance but needed an understandable framework to make it meaningful for the wider FCO. Soon after my appointment as Director General Finance, I launched the '5\* Finance Programme'. This provided an intuitive framework for the FCO. The aims were to function more effectively and become recognised as a Whitehall leader in the field. The structure of milestones ranging from 1\* (poor) to 5\* (excellent) was based on NAO's December 2003 report on managing resources to deliver better public services.

The programme started in September 2007, with an initial self-assessment of 2.5\*. A small programme team took forward the work. It led a handful of projects itself, with almost all the work done outside the team in the finance community. The early days concentrated on IT systems and processes, aiming to raise worldwide process compliance, simplify routines and speed up the adoption of audit recommendations. The FCO also strengthened the units that link the overseas network with central Finance and introduced six new professional finance training schemes.

In autumn 2008 the programme reached an intermediate milestone of 3.5\*, which the NAO endorsed as a reasonable summary of progress. An internal review in early 2009 concluded that after securing a sizeable number of technical gains, the next step was to mainstream those improvements. Transforming financial management was about step changes in quality beyond the boundaries of the core finance community. The business had to be engaged, and the finance side was now in a position to push this forward.

The FCO focussed the next 4\* stage on improving the quality of management information available to senior managers in the UK – 'Firm Finance Facts'. It reached 4\* by November 2009. The current 4.5\* phase – 'Far Flung Finance', due to end in July 2010 – is about pushing out into the wider FCO and the overseas network. Crucially, it adopts an ambitious maturity-based approach, driving the transformation throughout the organisation. The NAO – observers on the Programme Board – will assess the FCO on the maturity of its financial management after this phase. They are working with FCO on the assessment methodology to be used later in 2010.

## IFRS and Beyond

The Third CIPFA/ICAEW Public Sector Conference 2010

How did the FCO get this far? I believe that the main lessons of this innovative programme have been:

- The FCO put time and energy into making the sometimes hackneyed concept of 'senior management buy-in' real. The FCO Board undertook significant financial training and Peter Ricketts, Permanent Under Secretary, and Non-Executive Director Alistair Johnston, of KPMG, have led 5\* from the front.
- The FCO understood that the programme was far wider and deeper than a few technical fixes or new IT applications. The programme has been about creating a step change in the quality of financial management rather than just focusing on structures and processes, leading to greater organisational maturity.
- Being more than business as usual, a small, dedicated change programme team was created, blending the business and finance sides. The approach embraced systems (how we manage the finances) processes (what exactly we do) and practices (how well we do it).
- The worldwide network has been engaged in the 5\* brand and programme, through a focused communications effort and a popular series of short self-help guides that help overseas posts to diagnose their financial competence and to work on simple ways to improve their performance towards 5\*.
- 5\* is not itself about making efficiency savings but about enabling better financial management so that the FCO is better placed to make required efficiencies.

The Whitehall finance directors look forward to the next phase of this endeavour.