

Submission to the Scottish Parliament Finance Committee Inquiry : Strategic Budget Scrutiny

1. Executive Summary

1.1 There are five generally recognised themes of world class financial management: financial governance and leadership, financial planning, finance for decision making, financial monitoring and forecasting and financial reporting. . It is within these themes that CIPFA's comments are framed which, at the outset can be summarised as follows:

- Financial Governance and Leadership – a change in financial culture within public service bodies is required which will require strong leadership to achieve. The Director of Finance should be a key member of the leadership team.
- Financial Planning – re-prioritisation of public services within a reduced financial envelope will be required. This will place strain upon traditional public sector budget setting processes which focus on the short-term.;
- Finance for Decision Making – key long-term decisions will be required the focus of which may be on disinvestment in some services rather than investment. These decisions will require accurate benchmarked data;
- Financial Monitoring and Forecasting – which will require a direct link between budgeted spend, the robustness of ongoing monitoring. The appropriate financial skills to achieve this are crucial at all levels; from elected or non-executive member level to the manager charged with devolved budget responsibilities;
- Financial Reporting – the move to international financial reporting standards provides opportunity to improve the accountability of public entities in terms of transparent financial reporting.

1.2 Each of these areas is considered in further detail.

2. Financial Governance and Leadership

2.1 The financial culture of public sector organisations will need to change quickly. These organisations have lived through a period of substantial growth and will need to adjust quickly to the reality of the economic climate we now face. It is vital that the tone is set from the top - by top management setting out clearly the collective and individual responsibilities for financial management. Top managers must ensure they are seen to be taking their financial management responsibilities seriously. Non executives, whether elected or non elected, must hold officers to account for financial performance.

2.2 As an Institute, we have consistently advocated that the Director of Finance, a qualified accountant, should be a member of the top executive team. This is to ensure that financial issues are given due consideration at the point of both policy planning and decision making. We are currently finalising a principles based statement on the role of the modern public sector director of finance. The statement was based on research, one of the findings of which was that the view of the Finance Director as a traditional accountant is firmly rooted in the past. This has been largely replaced by a creative and innovative finance directors who can engage, communicate and run a business. The forward thinking finance

director now takes responsibility for a number of areas, and is expected to adopt a corporate overview to achieve strategic objectives. In order to do this, the finance director needs to have a seat at the top table where s/he can influence and shape developments.

- 2.3 In local government in Scotland, 25 of Scotland's 32 finance directors (the 'proper officer') are members of the corporate management team¹. This position may however vary within other Scottish public sector bodies. CIPFA's statement is expected to emphasise the principle that a public sector director of finance should be a key member of the leadership team.

3. Financial Planning

- 3.1 In recent times, the focus of public sector organisation and their financial planning processes has been about spending money. It is widely expected that this growth will not continue. It is however, unclear how long and how deep the reduction in spending will be. This means that the budgeting process of the Scottish Government and public bodies themselves will now have to consider making serious choices between priorities in order to operate within the reduced financial envelope. This represents a significant cultural shift for many of these organisations as well as for the budgeting process itself.
- 3.2 Consideration needs to be given to how incremental budgeting is used by the public sector body. Incremental budgeting is an approach to budgeting which takes the current year as its base and modifies that base figure to arrive at next years budget. One of the inherent weakness of this approach to budgeting is that often the base year is not examined robustly and more energy is devoted to the expansion areas. In the current climate energy will require to be diverted into examination of the base budget. There will also need to be far greater rigour around bids for new monies.
- 3.4 It is vital that the depth and length of the required reduced spend is communicated to public bodies quickly in order that the scale and duration can be reflected in their financial assumptions within their financial plans. It is vital that the revised planning assumptions are then communicated across the organisation in order to ensure that everyone understands the new financial environment as well as to all community planning partners where appropriate.
- 3.5 Re-prioritisation may result in disinvestment in some services. It is vital that such disinvestment is managed in a planned and considered way. Such decisions will be difficult and organisations need to consider how to involve communities in making these decisions.
- 3.6 There are a number of funding pressures which public sector organisations face, most noticeably due to demographic changes. Liabilities where known will be recorded and reflected in the financial statements (discussed further below). The annual budget however will only allocate resources to anticipated level of demand for that year. We need to begin to take a longer term view of all the financial commitments which organisations are likely to face in order to inform future taxation decisions or perhaps to consider whether services "free at the point of delivery" is something that the public sector can afford to continue with.
- 3.7 To enable the type of longer term decision making that is envisaged to take place, a significant shift away from an annualised budget process is required. The current climate will almost certainly bring a tension between the current short-term focus of budget processes and the need for longer term strategic financial planning. Directors of Finance will be required to utilise all tools available to

¹ Source: Audit Scotland Overview of The Local Authority Audits 2008

smooth the position between financial years. Utilisation of reserves, (where the public body can maintain reserves) is a key part of financial planning. Proper use of reserves will require clarity of purpose for their use with the appropriate level of reserve required, a matter for each public body.

4. Finance for Decision Making

- 4.1 In the recent past, finance for decision making has been more concerned with providing the financial information to support investment appraisals. In the current climate, it is more likely that decisions will be concerned with disinvestment and it is vital that the organisation has the processes in place to support such decisions. Benchmarking of costs is central to ensuring that value for money is obtained on an ongoing basis. In an economic downturn, it can become a tool for comparing the efficiency of service delivery. Shared services by public sector bodies may be an area where efficiencies can be gained but it is vital that both existing costs of service delivery as well as current performance standards are known in order to enable true comparison to be made.

5. Financial Monitoring & Forecasting

- 5.1 Having set financial plans for the year, ongoing and regular monitoring is required to monitor performance against budget. We understand that in some organisations, financial information is available to management and board within three days of a period end. But this isn't necessarily the norm. The consequence is that timely information is available for decision-making and where necessary timely corrective action. Where timely or inaccurate information is not available, the converse is then true in that any corrective action required is too late and the adverse impact is felt not only in the current financial year but potentially in later financial years
- 5.2 In the modern progressive public sector organisation budget responsibility will be devolved to front-line managers. There are many benefits to this approach including the key outcome where managers assume greater ownership for the resources under their control. To undertake this responsibility however, managers must have the necessary financial skills in order to understand the process and ultimately to provide accurate forecasts. There are recent examples in the public sector in Scotland where a disconnect between expected budgeted spend and actual spend has resulted in significant impact upon both current and future service delivery. In a period where the financial envelope will almost certainly reduce the ability of a public body to react in such circumstances will be even more limited. Financial skills should not of course be limited only to managers. Elected and non-executive members should also have the appropriate skills to understand the financial information reported to them and to bring objective challenge to officers. The combination of skilled managers, accurate forecasting enables the necessary financial leadership to take place and where financial problems may be emerging the necessary decisions can be taken proactively.

6. Financial Reporting

- 6.1 The Scottish public sector is in the process of converging with international financial reporting standards (IFRS). The published financial statements of public sector bodies will, in future, be considerably different in both form and in substance.
- 6.2 One specific area where the benefit of enhanced accounting and disclosure is demonstrable and can be compared with a policy solution is the recognition of financial instruments.

Financial Instruments – Icelandic Bank Deposits

- 6.1 A current case study, is the investment by some Scottish local authorities in Icelandic banks. Eight Scottish local authorities had deposits of the order of £45M at the point of the collapse of the Icelandic banks in October 2008.
- 6.2 Local authorities will have to assess the extent to which real impairment ('bad debts') will require to be accounted for and reflected in their financial statements. This means that provision will require to be made. The Scottish Government has elected to enable local authorities to smooth the effects of any impairment over two financial years. The benefit to users of the financial statements is that the financial statements will not only reflect the accounting consequences but will also reflect the policy consequences.
- 6.2 There may be no immediate or direct impact upon the Scottish Government budget if the UK Treasury is successful in its efforts to recover the monies. There is a risk however that up to £45M may be unavailable in future for public service delivery in Scotland. This however highlights the need to account transparently for bad debts due to impairment and for the results to inform the financial planning process.

Financial Instruments - Financial Guarantees

- 6.3 A feature of public service management was that financial guarantees were provided to external organisations. These guarantees may have been provided to advance local economic policy to secure local industry or to attract inward investment. These guarantees were not required to be reflected in the financial statements under UK GAAP and because of how the guarantees were issued, generally were not a feature of financial planning. International financial reporting standards however require that such guarantees should be recognised as a financial instrument.
- 6.4 Where there is no little or no probability that any guarantee will have to be paid then there is no impact upon public resources. Where however there is in fact a probability that the guarantee may have to be paid, then this is charged by the public body providing that guarantee. In an economic downturn, the likelihood of guarantees being paid is likely to increase which means that a greater charge will be required to be made to financial statements.

PFI

- 6.5 There has been considerable debate about prospective changes to the treatment of private finance initiative (PFI) and public private partnership (PPP) schemes when international financial reporting standards are introduced. That debate has focused upon one of the consequences, albeit a key one, which is that the assets with these projects, currently 'off-balance sheet', will in future fall to be recognised on the balance sheets of public sector bodies. In addition, the related liabilities to pay for the assets will also be transparently reported. While there will inevitably be further debate on the impact that this may have on forward resources, the development in its widest sense means that policy makers and managers will in future have access to transparent financial information about the assets required for the provision of services irrespective of funding mechanism.