Audit Committee, 6 September 2016

Management accounts process

Executive summary and recommendations

Introduction

The NAO's report to Audit Committee and Council following their 2016-17 audit was critical of the variance analysis in HCPC's management accounts and recommended that HCPC "should agree on the level of granularity and type of detail needed in its management accounts for budget holders and for Council".

This paper sets out the management accounts process for explaining variances, recommended criteria for EMT and Council to adopt in discussing them, and a proposed response to the NAO's recommendation.

Decision

Audit Committee is asked to review and approve the management accounts process and the criteria for discussing variances and the proposed response to the NAO's recommendation.

Resource implications

None directly

Financial implications

None

Appendices

Appendix 1: Proposed management accounts process for explaining variances and recommended criteria for EMT and Council discussion
Appendix 2: NAO recommendation and proposed response

Date of paper

26 August 2016

Appendix 1: Proposed management accounts process for explaining variances and recommended criteria for EMT and Council discussion

Control objectives of the management accounts process

HCPC's management accounting process is a key internal control, designed to help to achieve the following objectives

- To contain costs and provide accountability. Budget holders are responsible for delivering their departmental workplans within the agreed budget, +/- 5%. The management accounts are the measure of success for this objective. Overspends and underspends can be challenged by EMT, Council and by the Chief Executive in the budget holder's appraisal process;
- To ensure accuracy in the financial records. The process of reviewing management accounts should identify significant errors, eg significant omitted accruals, or significant mispostings;
- To ensure that departments are on track to deliver their workplans. Departmental budgets reflect workplans, and significant overspends and underspends compared to budget are an indication of possible problems in delivery of the workplan. However, departmental reports are the main control for this purpose;
- To identify additional resourcing requirements. Some of HCPC's services are demand led, and in those areas an overspend against budget may indicate demand in excess of expectations, and a need to increase the department's capacity either temporarily or permanently. However the month 3[1], 6 & 9 reforecasting processes are the main control for this purpose;
- As a product of all the above, to help ensure HCPC's effectiveness and value for money.

The management accounts are produced monthly and reviewed at three levels:

By the budget holder and Finance. Each budget holder receives a report for his/her department, showing actual spend vs budget for the last month and for the year to date, line by line (for example, Partners' fees, Partners' expenses). These reports are supported by a transaction listing which enables budget holders to see the transactions making up each line item total, so as to query any unexpected values. The departmental reports are available from the 4th working day of each month. The budget holder is expected to review the reports and query significant unexpected variances. For example, an unexpected underspend may be because a Purchase Order has not been Goods Received. The budget holder is also asked to provide a brief explanation of significant variances from budget (see below for definition of "significant") and to confirm whether the variance it is a timing difference which will reverse later in the year, or is a permanent variance.

By EMT. HCPC management accounts are included within the Finance Report to each monthly EMT meeting. The HCPC management accounts show actual spend v budget for the year to date for each department and for HCPC as a whole, broken down into sub-totals for payroll and non-payroll, and the variance explanation provided by or agreed by the budget holder.

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[1] FTP reforecast after 3, 6 and 9 months; other departments reforecast after 6 and 9 months

By Council. The HCPC management accounts are also included in the Finance Report to Council.

What is a significant variance?
The management accounts for EMT and Council need to explain variances that are significant in the context of HCPC's overall expenditure budget of £31.4m, without obscuring the key messages with excessive detail. Therefore Finance will normally only ask budget holders to explain individual line variances (or confirm variance explanations put forward by Finance) that are greater than £30,000 **and** 5%. If there are several small variances which add up to an overall variance greater than £30,000 and 5%, we will ask for explanations for the small variances so that we can adequately explain the overall variance. We may also sometimes ask for explanations for variances below these thresholds if they are unexpected or potentially sensitive, or as part of ensuring we understand the department's budget.

However, budget holders should normally want to satisfy themselves about variances that are significant in the context of their own budget. The value threshold which is "significant" for each budget holder is for his/her judgement but could be £2,000 for a small department or £20,000 for FTP.

How should significant variances be explained?
Wherever possible, budgets should be set and variances should be explained in terms of units of activity and costs per unit. For example, the budget for partner expenses in a given period is an assumed number of days' activity times the assumed expense per day. The variance will be a combination of quantity (more or less days actually charged than budgeted) and price (actual expenses per day more or less than budgeted).

Planned activity levels in the budget should be consistent with the departmental workplan, and actual activity levels cited in variance explanations should be consistent with departmental reports.

Wherever possible, variances should also be described as either timing differences or permanent under/overspends. Timing differences are one of the main causes of variances, since the timing of activities is usually uncertain when budgets are set. For some kinds of activities, for example events or consultants costs, slippage at the start of the year can be made up later in the year so an underspend can reasonably be treated as a timing difference rather than a permanent saving. For demand led costs, an underspend due to lower than expected demand early in the year could reverse if demand increases later in the year, so budget holders should initially be cautious about treating lower than expected demand as a permanent saving. Conversely a vacant post will almost always be a permanent saving.

What should discussion at EMT and Council focus on?
The management accounts are part of a wide range of regular management information and performance indicators produced for EMT and Council, and the amount of time EMT and Council spend discussing the management accounts will be proportionate to other issues requiring attention. Therefore it is appropriate for EMT and Council to take a risk based approach and focus on the more significant risks, if any, identified in the management accounts.

The main points EMT and Council should focus on in reviewing and discussing the management accounts should be where income is significantly under budget and/or where expenditure is significantly over budget. Those instances will be covered in the variance commentary.

Significant underspends should also be covered in the variance commentary and should be noted, as they could indicate a risk of failure to deliver objectives, but the main vehicle for discussion on that risk is likely to be the relevant departmental report rather than the management accounts.

Where income and expenditure are on track, the management accounts will be noted but EMT and Council are unlikely to need to discuss them in detail. Similarly, if the explanations for variances are clear and comprehensive and consistent with other management information, and the position appears to be under control, then there will not necessarily be extensive discussion.

Avoiding perverse incentives
EMT and Council should encourage an open approach to budget setting and management accounting. An excessive or punitive focus on underspends could incentivise budget holders to spend so as to avoid underspends, resulting in poor value for money. An excessive focus on variances in either direction could incentivise budget holders to eliminate variances by making unnecessary accrual or prepayment adjustments.

Appendix 2: NAO recommendation and proposed response

In line with our audit plan, we sought to take assurance from the monthly management accounts as a high level control. We looked for evidence that HCPC had a robust budgeting process, was explaining all significant variances, and using the management accounts to identify and correct errors. HCPC produces management accounts at two levels: firstly at a detailed level for budget holders, and secondly at a more strategic level to enable the Council to carry out its oversight role. We found that:

- HCPC investigates significant overspends, but does not always investigate underspends. In some cases this will undermine the variance analysis process, particularly as budgets are prudent, making underspends more likely.
- Variance explanations tend to break down variances into a more granular level of detail, rather than explaining their underlying causes. High-level analysis, for instance comparing the financial data to non-financial data on activity levels in the different departments, would help give a more strategic perspective.
- There was variable evidence of budget-holder review. While we could see that variance analysis was being undertaken and misstatements corrected for the Finance and FTP departments, evidence of this from other departments was more limited. Active budget-holder review helps HCPC identify errors in the underlying financial records, and better explain any variances.

These weaknesses meant we were unable to rely on this control for audit assurance, and had to increase our sample sizes. More significantly these issues have wider implications for HCPC and we suggest that relatively minor changes could significantly improve the quality of information provided to the Council. The management accounts could for example: explain the reasons behind significant under as well as overspends; consider HCPC's financial position strategically within the context of changes in operating activities; and consider whether variations are as a result of timing differences, indicate that remedial action is required, or indicate that there are opportunities for HCPC funding to be used in a different way than was initially planned.

We recommend that HCPC should agree on the level of granularity and type of detail needed in its management accounts for budget holders and for Council.

Proposed HCPC response

Our management accounts process is a key control designed primarily to contain costs and provide accountability. The process is part of a much wider framework of controls which help EMT and Council perform their management and oversight roles.

Where applicable and where the values are significant, we do aim to explain variances in terms of units of activity, and to differentiate permanent variances from timing differences. Finance continues to work with budget holders to develop budget setting and variance analysis in those terms. To ensure focus on significant variances, we will normally only comment in the HCPC-wide management accounts on variances that are greater than £30,000 and 5%.

EMT and Council will continue to focus more attention on overspends than on underspends, which is appropriate. The management accounts together with the month

6 and month 9 reforecasts[2] are the main control against overspends. While an underspend in the management accounts could be indicative of a risk to achievement of departmental objectives, the main control against departments not achieving their objectives is the departmental reports, not the management accounts.

The month 6 and month 9 reforecasting processes do reflect changes in operating activities and consider opportunities for reallocation of resources.

The budget setting, management accounts and reforecasting processes are effective. In 2015-16, total actual expenditure was within 1% of both the original budget and the month 9 reforecast. Income was 4% over the original budget and 1% over the month 9 forecast. The figures in the month 12 management accounts were carried through into the audited statutory accounts without any adjustment to gross income or expenditure being necessary.

[2] FTP reforecast after 3, 6 and 9 months; other departments reforecast after 6 and 9 months