Submission
No 10

INQUIRY INTO INQUIRY INTO FINANCIAL REPORTING

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Theme:

Summary

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Mr Paul Gibson MP
Chair
Public Accounts Committee
Parliament House
Macquarie Street
Sydney NSW 2000

30 July 2010

Dear Mr Gibson

Inquiry into the quality and timeliness of financial reporting

KPMG is pleased to present its submission to the Public Accounts Committee in relation to your inquiry into the quality and timeliness of financial reporting by NSW Government departments and agencies.

The Committee's inquiry has established the nature of the issues; the next step is to implement the improvements required and clarify the accountability framework.

We believe this is an issue of immense importance and relevance in today's environment and commend timely action aimed at improving the quality of financial information provided to Parliament.

If it may be of assistance, we would welcome the opportunity to discuss our submission with you and the Committee.

Yours sincerely

Andrew McMaster
Partner

Contents

1. Introduction and background

Government departments and agencies in NSW are facing a period of great change and complexity, and the magnitude of current reform processes, including agency amalgamations, should not to be underestimated. The worst of the global financial crisis may be over, with public sector revenue streams showing signs of recovery, however, Government entities are confronted with ongoing pressures to find service delivery and administrative efficiencies. Any growth in costs must be contained in line with savings targets and sustainable revenue growth.

In this environment, it is more important than ever that Government entities have appropriate resources and processes to ensure the quality and timeliness of financial reporting and budgeting.

The pressure for efficiencies in budget estimates and the changes flowing from the Government's reform agenda have combined to increase the demands on finance functions. To drive the current focus on the effectiveness of financial reporting, agencies must be able to measure financial results quickly and accurately in order to ensure the quality and timeliness of information provided for budgeting and financial reporting purposes.

The inquiry by the Public Accounts Committee ("the Committee") into financial reporting by NSW Government entities is focusing on:

- adequacy of current processes for the identification and correction of errors;
- identification of best practice procedures for financial reporting; and
- any impediments to the implementation of best practice procedures.

KPMG is of the view that this is an important issue, and fully supports the Committee's aim to improve the quality of financial information and decision-making by NSW Government departments and agencies. This submission provides an overview of the key elements of this issue and an approach to quality improvement.

2. The key issues

KPMG's understanding of the key issues of concern being addressed by the Committee are based on our very extensive experience in financial reporting matters, our strong public sector knowledge and experience, and our review of the following documents:

- The Auditor-General's report to Parliament Volume Four 2009; and
- Transcripts of the meeting of the Public Accounts Committee on 5 May 2010.

In broad terms, the Auditor-General is concerned not only about the impact of accounting errors on the quality of year-end financial reporting, but also the implications for the State's budget if this process in June of each year is not based on robust and timely financial data.

The key areas of concern that have been identified by the Auditor-General are:

i. Hard close reporting –

The “hard-close” approach for year-end financial reporting and audit purposes is a routine and widely used process in the private sector, and any moves to implement this approach in the public sector are strongly endorsed by KPMG.

It is particularly useful and effective in a multi-entity environment such as the NSW public sector, where consolidated accounts are prepared annually by Treasury for the General Government Sector (GGS) and Total State Sector (TSS) pursuant to the Public Finance and Audit Act 1983.

The key benefits of a hard close approach for year-end financial reporting are:

- the early identification and resolution of accounting recognition and measurement issues, particularly in relation to valuation matters which can be quite complex; and
- the early identification and correction of errors, which impacts the quality of financial information.

The other major and related benefit of a hard-close approach is that the early resolution of accounting issues. Correction of errors will result in more robust data being submitted for budgeting and forward estimate purposes.

Also of value in this process is that the Auditor-General will have the opportunity to spread the timing of audit procedures, allowing a more orderly deployment of resources and more time to focus on the key issues.

It is noted that Treasury is supportive of the hard close concept, and conducted a pilot exercise with 15 large agencies in respect of financial reporting for the year ended 30 June 2010. We understand that a review of the results of this pilot exercise has yet to be completed.

ii. The nature and extent of errors in financial reporting –

The extent and nature of errors in agency financial reporting are often considered to be immaterial from both an individual entity and consolidated (GGS or TTS) standpoint, however, the central issue in our view is that any significant, recurring errors do undermine the quality of financial reporting.

It was noted in the Committee’s meeting of 5 May 2010 that agencies have the ultimate responsibility for the quality of their financial information, and this is dependent upon the competency of agency accounting resources. The cost implications for agencies of seeking to improve accounting functions was also noted, with reference to the skill level and remuneration of accountants in the public sector.

Another relevant issue in this regard is the impact on accounting resources of complexities arising from the agency amalgamation reforms.

Treasury also indicated their view that, with the recent release in August 2009 of their policy document "Internal Audit and Risk Management Policy for the NSW Public Sector (TPP09-05)", they expect to see an increase in the standard of agency reporting. This view has regard to the role of Audit Committees which are now required to have a majority of independent members.

Another relevant issue in this regard is that a reasonable proportion of errors result from complex valuation issues which generally are only identified at each year end as they are balance sheet (and largely non-cash) items. This is an indication that agencies and Treasury do focus on the operating statement from a financial accountability and budgetary standpoint. This apparent lack of emphasis in respect of the balance sheet needs to be investigated to ascertain if this mindset is impacting the overall quality of financial reporting.

Our views in relation to errors and the responsibility for agency financial reporting are summarised as follows:

- the implementation of a hard close approach for financial reporting will greatly facilitate the early identification and correction of accounting errors;
- the issue of the quality of public sector finance functions and accounting resources needs to be formally investigated and the actual position and any issues arising identified; and
- the impact and effectiveness to date of Treasury policy TPP09-05 should be ascertained through surveys and reviews, and the implications for the quality and timeliness of financial reporting determined.

iii. The significant and consistent budget overruns at a number of large agencies –

The Auditor-General has noted his concerns in respect of the significant and consistent budget overruns that have been occurring at several large agencies. This finding brings into question the veracity of the budget-setting process and the robustness of underlying financial data.

Any response to the Auditor-General's concerns should be based on an understanding of the factual, underlying reasons for the recurring budget variances.

In KPMG's view, these reasons can be ascertained by a detailed review of the budgeting and forecasting processes applied in major agencies. Based on this review, a range of better practices could be identified based on a "gap analysis" between current and better future practices, and an implementation plan developed.

This approach would assist in the transition of current approaches away from historical budgeting towards a methodology based on predictive modelling.

3. KPMG viewpoint

KPMG's overall view is that a clear strategy to improve the quality and timeliness of financial reporting by NSW Government departments and agencies needs to be developed through a collaborative approach between the Committee, Treasury and the Auditor-General, and based on a clear vision of the required outcomes.

The current process for year end financial reporting is reasonably clear and can be broadly summarised as:

- Treasury issues guidelines and accounting policies that govern financial reporting by agencies, and prepares the consolidated (GGS and TSS) accounts;
- agencies are responsible for applying the guidelines and producing year-end accounts which are accepted and relied upon by Treasury; and
- the Auditor-General checks compliance with the guidelines, accounting policies and other applicable reporting requirements.

There is, however, no clear accountability for the overall quality and continuous improvement of this reporting model, with errors rationalised based on materiality and put down to the quality of agency accounting resources.

A sensible strategy over time with a defined pathway to continuous improvement needs to be developed and implemented. While there is a need to start now, reform would take time and any change needs to be based on a reliable and independent assessment of the underlying facts and circumstances.

There will be costs associated with any improvement process. The value proposition for an improvement in the quality and timeliness of financial information is that, while difficult to measure, it should lead to better overall rigour, better management, and better decision making in respect of both regular financial reporting and budgeting processes.

4. Pathway to improvement

KPMG recommend that the pathway to improvement of the financial reporting processes of NSW Government departments and agencies should be based on the following approach:

- Clarification of the accountability framework in relation to year-end reporting;
- benchmarking government entity finance functions;
- implementing a "quality close" process; and
- assessing and improving agency budgeting and forecasting processes.

The key individual components of this approach can be broadly summarised as follows:

i. Information gathering:

- review and benchmarking of the finance functions of larger Government departments and agencies
- benchmark quality and timing of financial reporting with other States and between agencies (for example, do other jurisdictions use “hard close”?)
- review of the effectiveness of agency governance arrangements in relation to year-end reporting at 30 June 2010 following the introduction of TPP09-05
- benchmarking relative size/resources of Treasury and the Audit Office with other States: are they adequately resourced to facilitate implementation of improvements?

ii. Embed the “hard close” approach across the whole-of-Government:

- ascertain the regular use of full accrual accounting by agencies
- independent review of hard close pilot program introduced by Treasury for FY2010
- implementation of hard close methodology

iii. Improve Budgeting and forecasting:

- diagnostic review of processes at key departments and agencies
- ascertain if there is wasteful expenditures at the end of any financial year
- gap analysis and program to transition agencies to better practice

iv. Training programs for accounting personnel:

- regular workshops on key accounting standards: impairment; financial instruments; Land Under Roads; revenue; leases etc
- annual reporting seminar on key year end issues, Treasury policies, accounting standard changes

KPMG applies proven methodologies used in both the private and public sectors. (see Appendix I) These could be applied to assess the quality of finance functions, implement a hard-close approach, and improve the effectiveness of budgeting and forecasting processes.

KPMG submission to the Public Accounts Committee

Quality and timeliness of financial reporting by NSW Government departments and agencies

Appendix I: Recommended methodologies

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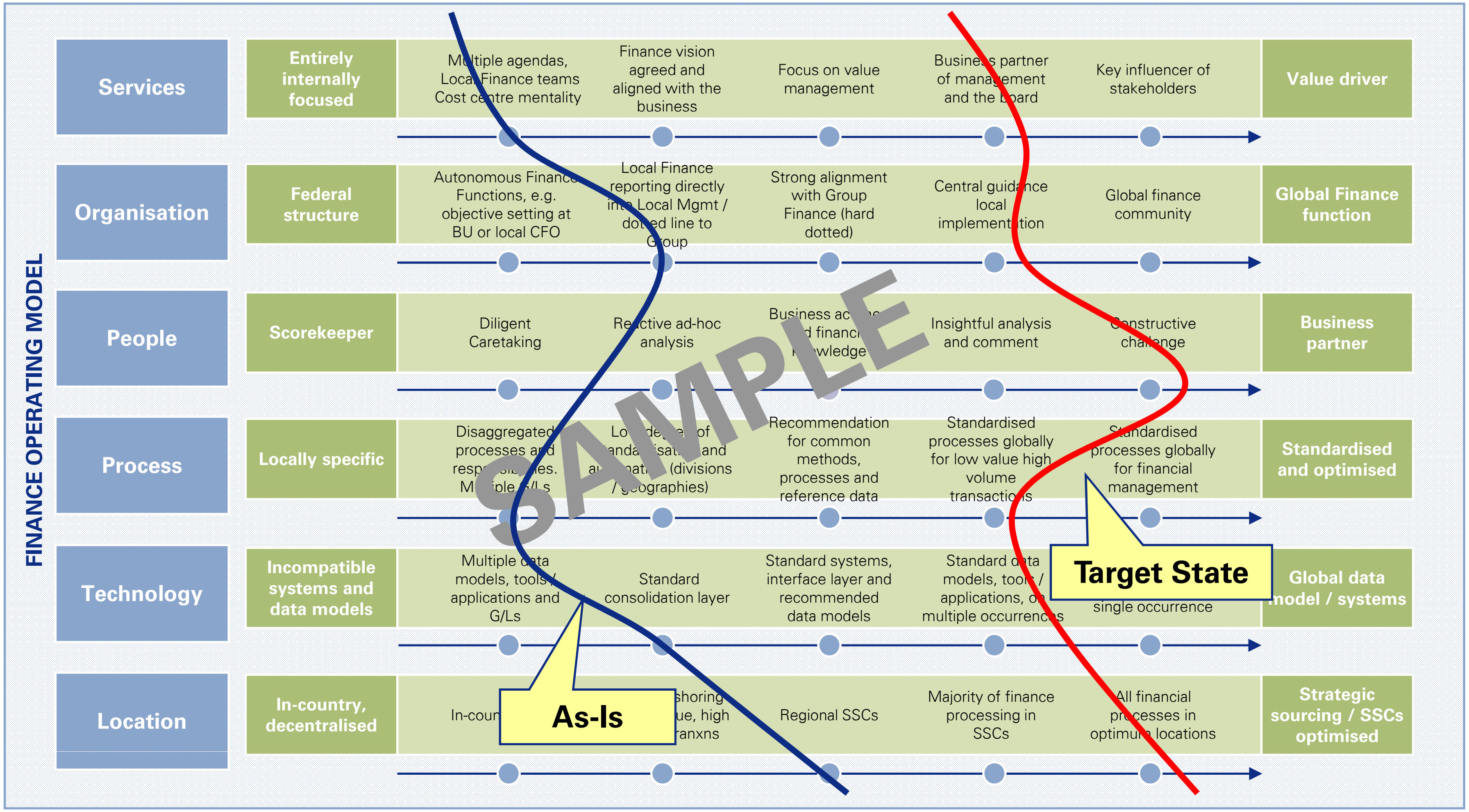
Assessing finance functions

KPMG's Finance Maturity Model is used for not only assessing the quality of an organisations finance function but also to provide a 'gap analysis' between the 'As-Is' and 'Target' states

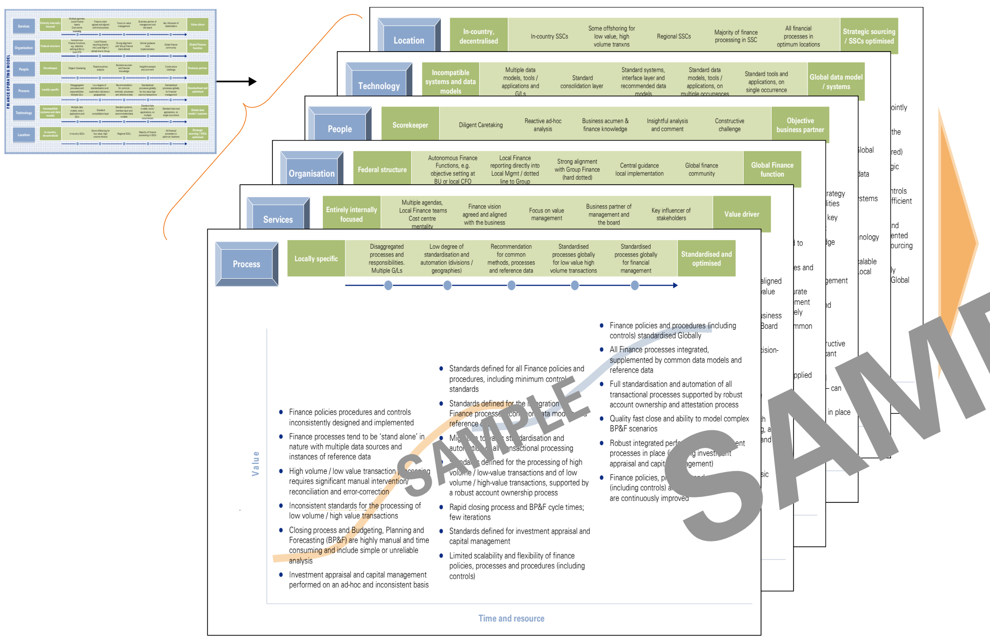


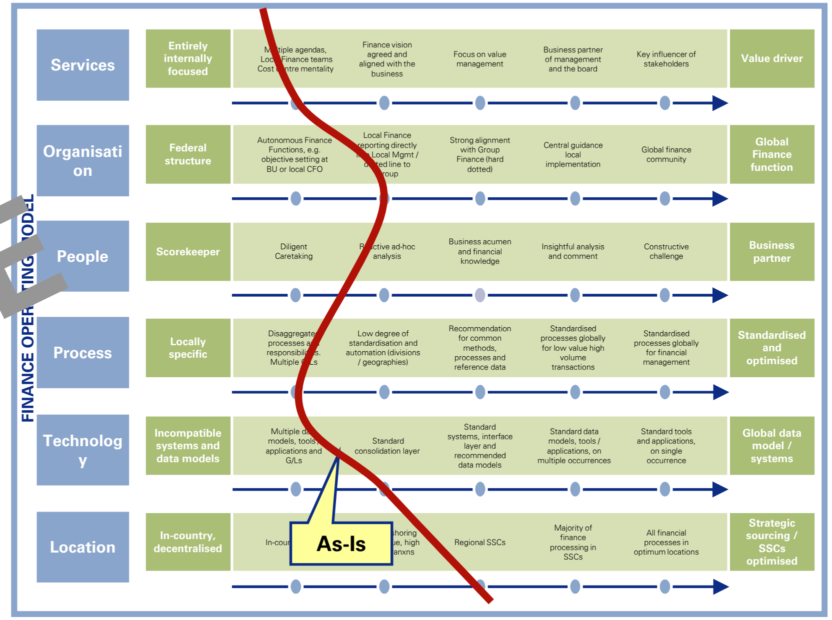
The finance maturity model is substantiated by a series of questions to support the summary 'As-Is" position

The maturity model covers six aspects of the finance function…

Services **Organisation** **People**

Processes **Technology** **Location**

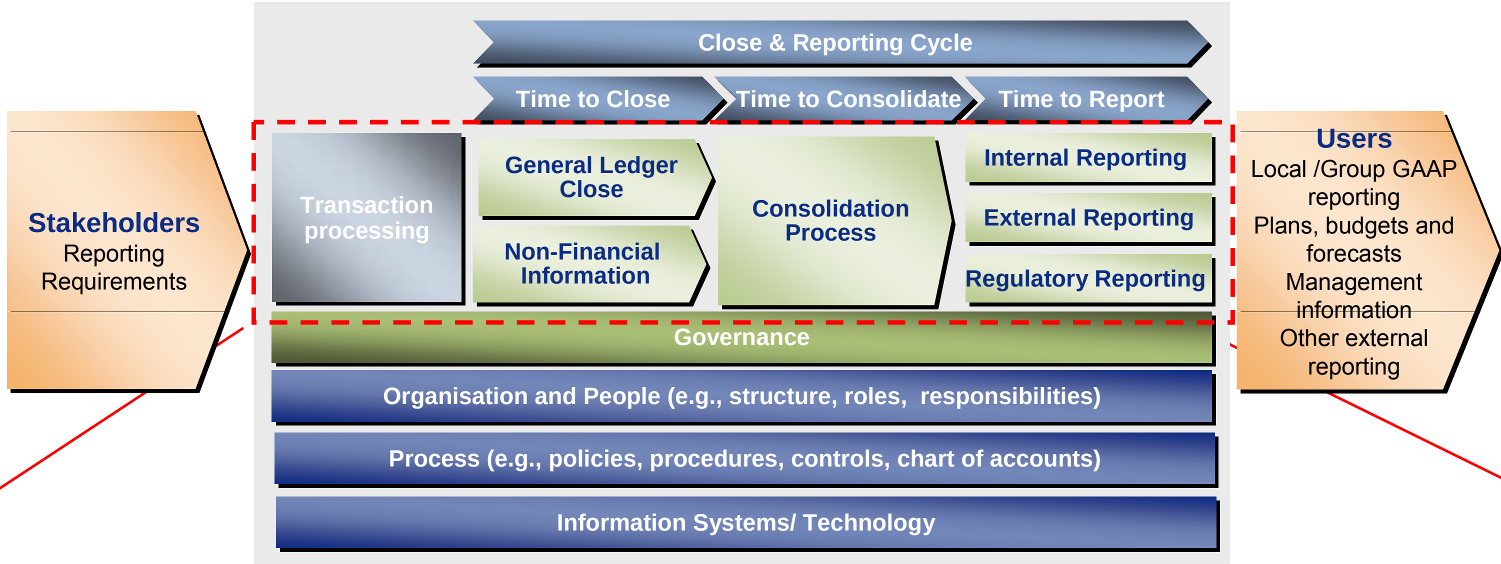




Quality Close process

The close and reporting process is NOT just about closing the general ledger, it also includes many important elements which can impact the cost, speed and quality of the close

A Quality Close has an encompassing effects on the whole of the Finance Function. It forms the foundation of Reporting and maintenance will include underlying functions such as Governance, Organisation & People, Process and IT – all of which we will assess at a high level in this engagement.



1. Transaction Processing
- Delays in cut off of sub ledgers
- Data integrity in source systems
- Correction of posting errors
- Incomplete entries (e.g., both sides of inter-company)

2. General Ledger Close
- No clear close guidelines or calendar for regional offices
- Manual workarounds, reconciliations and controls
- No materiality threshold for reconciliations
- Disparate ledgers across regions

3. Consolidation processes
- Multiple chart of accounts
- Non-consolidation entries being booked direct to consolidation tool
- Complex legal structure impacting upon consolidation approach
- Receiving of data from GL to consolidation system
- Inter-company reconciliation and eliminations performed at Corporate level

4. Reporting and analysis
- Dependency on spreadsheets
- Multiple un-reconciled sources of data for reporting
- Manual population of end-user reports
- Underutilisation of current technologies
- Inconsistent information reported across regions

KPMG

There are numerous inhibitors to adding value and increasing efficiency of the close and reporting process

INHIBITORS

Process

- Inconsistent processes
- Excessive use of spreadsheets
- Manual intervention
- Uncoordinated approach
- Redundant activities
- Lack of defined procedures

Risk and Controls

- Too many controls, or not the right controls
- Too much reliance on detective controls
- Timeliness of controls
- Lack of duty segregation

Effects

- Extended period to close
- Manual intervention
- Inefficient use of resources
- Unnecessary data checking
- High cost of close process
- Insufficient time to analyse
- Reactive decision making and poor planning
- Lack of accountability
- Poor quality of information
- Lack of transparency
- Lack of data integrity
- Proliferation of other reporting processes
- Late receipt of final numbers to tax
- Complex conversions of business unit G/L to entity-based statutory (tax) reporting

Technology

- Multiple systems
- Lack of integration
- Poor use of technology

Organisation and People

- Unclear roles and responsibilities
- Insufficient training
- The wrong/ too many people involved
- Challenging governance structures

Quality close and reporting is designed to help deliver the following benefits. . .

Greater Efficiency

- Reduction of low value-added work
- Reduction of work duplication
- More efficient task hand offs
- Increased use of automation
- Reduction in manual journal entries
- Enhanced ability to identify and correct errors

Earlier Information

- Earlier identification and correction of errors
- Improved speed of information delivery to the business
- Enhanced leverage of system functionality

Shorter Cycle Time

- Reduction in time to close books
- Time to focus on higher value added activities

Enhanced Controls

- Enhanced enterprise-wide close process coordination
- Greater reliance on preventive rather than detective controls
- Corrections of errors moved closer to the “source”
- Clearer definition of roles, responsibilities and segregation of duties
- Documentation of policies and control procedures

Reduced Complexity

- Reduction of complexity through process standardisation
- Greater visibility of close process
- Integrated and shared close calendar
- Appropriate setting and consistency of materiality thresholds
- Documentation and training on the close process

… which may help result in more time for finance to add value to the business

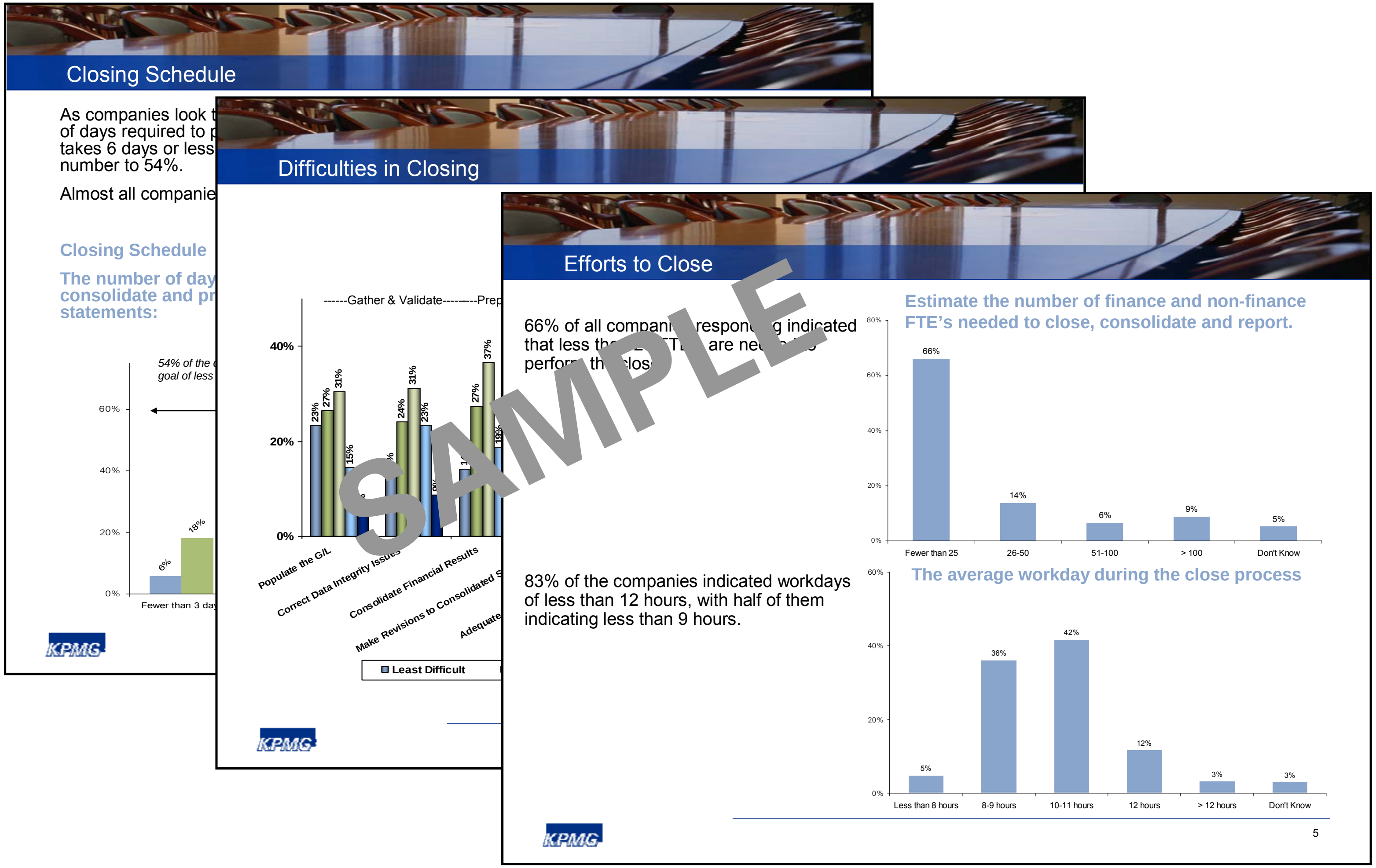
KPMG

What we see in the marketplace

Financial Close Process	Days	General Expectations	Observations
General Ledger & Operations	1-5	■ Close calendars are documented ■ Close calendars are adhered to ■ Not acting as a standalone operation	■ Many companies have documented close calendars ■ Supporting processes can always be improved ■ Interface weaknesses ■ Disparate ledgers impact standardisation
Consolidations	4-10	■ Inter company process are followed ■ Consolidation process non event ■ Technology supports a streamlined inter company and consolidation process	■ Inter company is complex in most organisations ■ Consolidations is complex due to organisations structures resulting in numerous correcting entries ■ Systems not integrated across the organisation
Reporting (Internal & External)	6-20	■ Reports generated seamlessly ■ Financial & Business reporting is in synch ■ Companies deliver operational reporting timely	■ Significant effort required to generate reports ■ Financial and business reporting synchronisation requires additional resources due lack integrated systems ■ Operations are demanding reports during and after the close
Earnings Release	Varies	■ Adequate preparation for the Audit Committee review	■ Inadequate preparation for the Audit Committee review ■ Board is demanding more analysis – volumes of data does not work
Filings	Varies – New Regs	■ Filings meet the regulatory requirements	■ Much confusion on effort to achieve the task ■ Audit Committee in the schedule is making it tight

Our benchmarks will allow you to assess your performance against other leading finance functions

Data and benchmarks have been collated for +300 international organisations

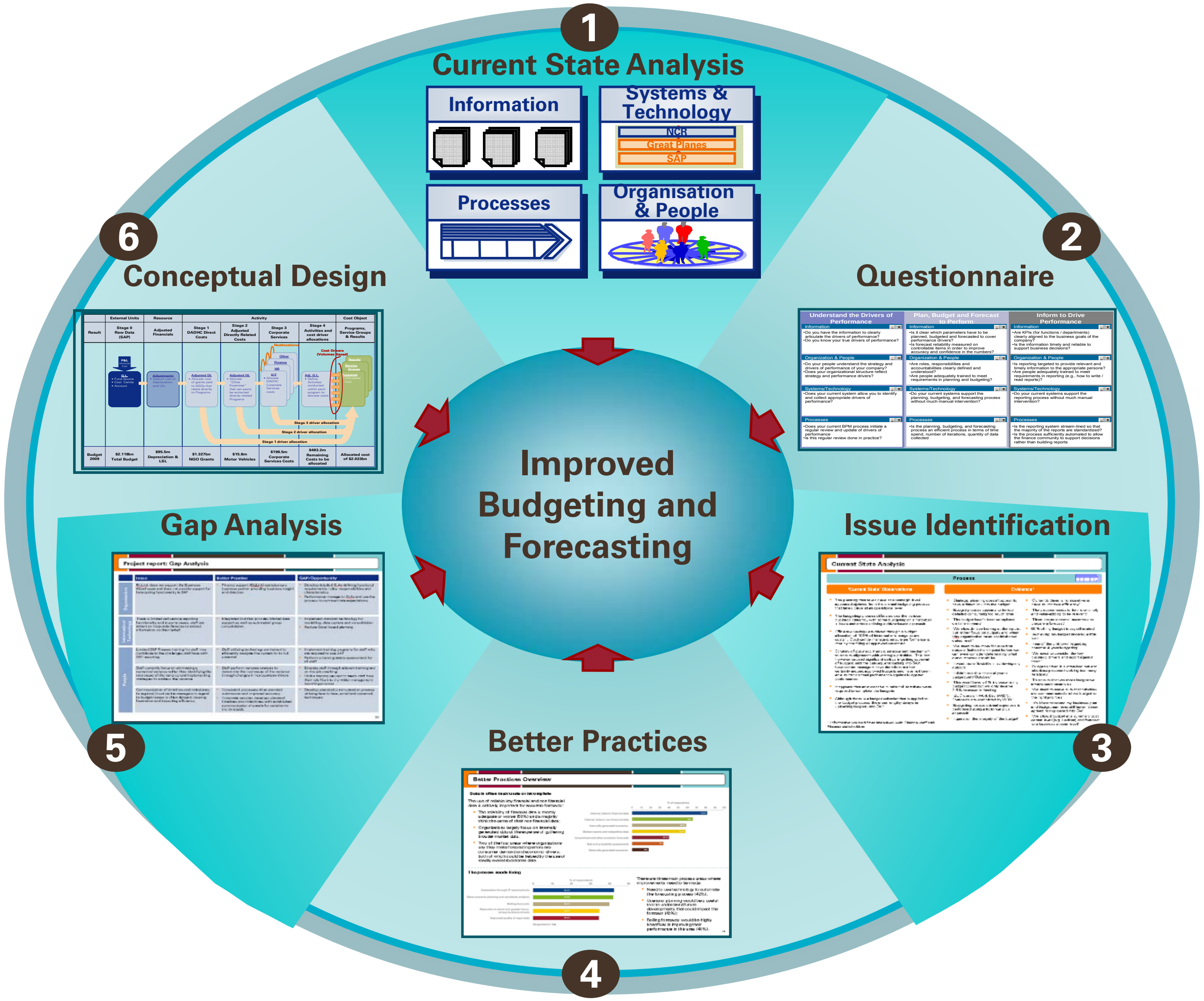


Budgeting and forecasting

An overview of our budgeting and forecasting approach

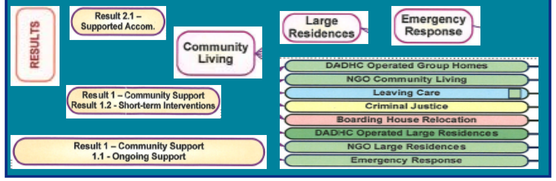
Approach Key

1. Obtained an overview of the current budgeting & forecasting processes;
2. Conducted interviews with key Corporate Services and business representatives to understand their issues with the current state and defined their future requirements;
3. Identified issues and categorised them according to information, processes, systems & technology and organisation & people;
4. Identified a range of better practices for consideration;
5. Developed a gap analysis between the current state and better practice;
6. Developed a future state conceptual design.



High-level Business Requirements form an input into our application of better practice to determine how Current State Budgeting and Forecasting will be transformed

High-Level Business Requirements



Current State Budgeting & Forecasting

Budgeting

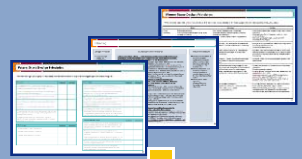
1. Most budgets are performed using a historical plus methodology
2. Timing of budget upload into SAP varies and can be significantly delayed
3. Operational staff have limited financial management experience
4. Multiple iterations in process
5. Excel based technology

Forecasting

1. Performed 'to the wall' (year-end)
2. Monthly intervals
3. Delay in providing executives with actual vs. forecast comparisons
4. Intensive effort to produce monthly forecasts

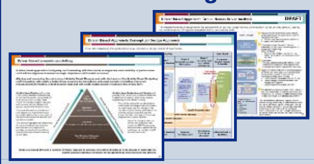
Better Practice

6.1 Overarching Design Principles

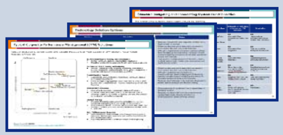


6.2 Process Design

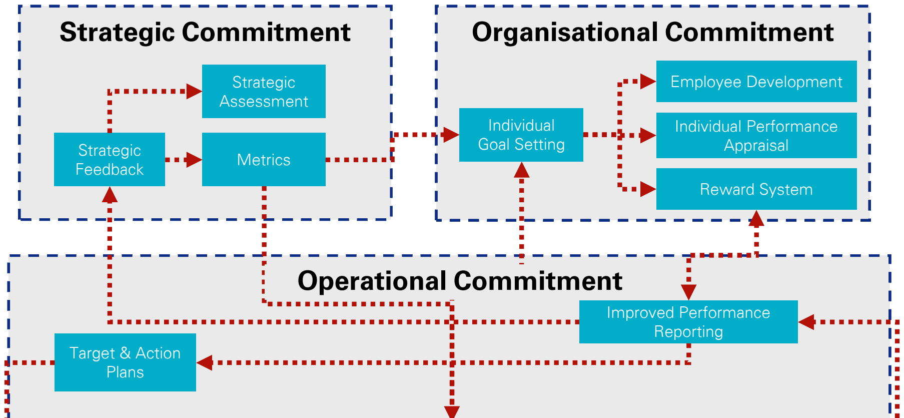
6.3 Driver Based Modelling



6.4 Tech Considerations



Performance Commitment Framework



Future State Budgeting & Forecasting Design

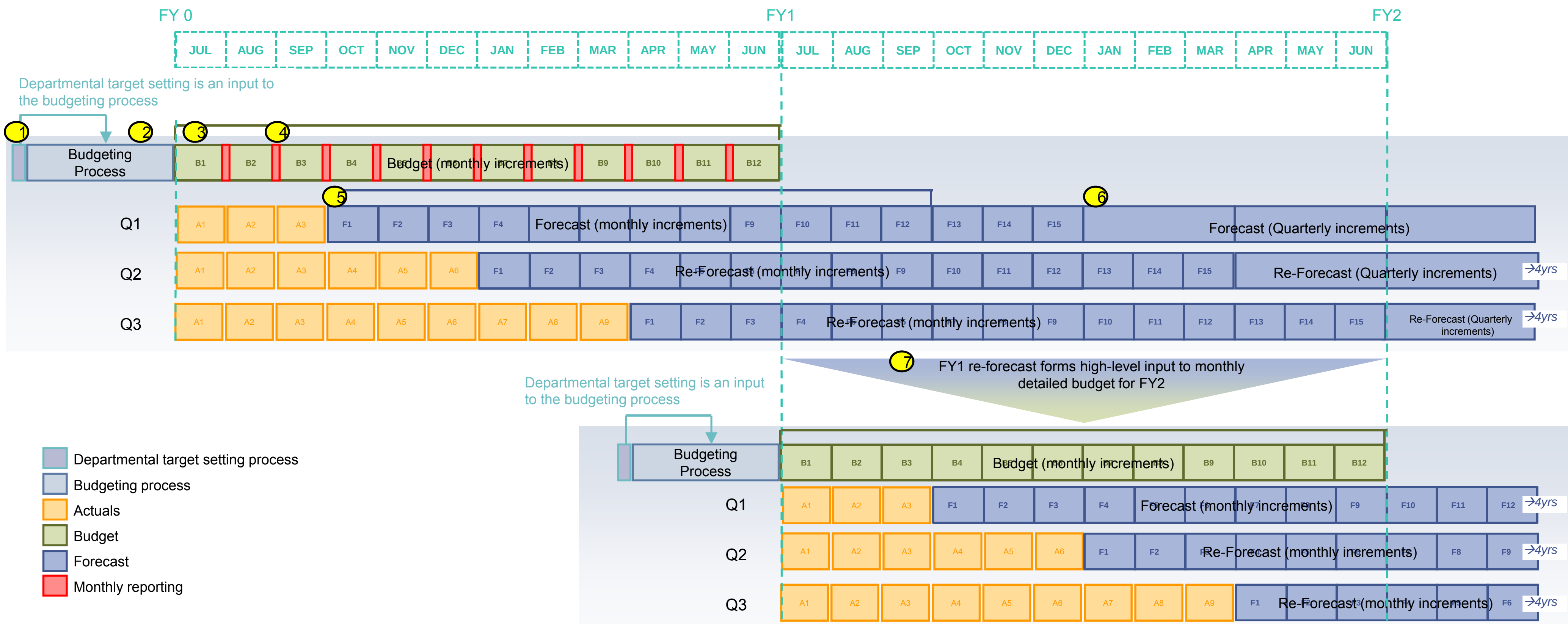
Budgeting

1. All budgets are performed using a driver-based model methodology
2. Budgets finalised, approved and uploaded before year-end
3. Staff have financial management expertise
4. Elimination of unnecessary budget iterations
5. Integrated technology solutions

Forecasting

1. Rolling forecasts
2. Monthly, quarterly, bi-annual and annual intervals
3. Comparison of actual to forecast is done in a more timely manner
4. Forecasting will be performed monthly until accuracy is established, then quarterly thereafter

Shifting planning away from historical budgeting and forecasting and moving towards a continuous predictive modelling method gives greater visibility into future operating performance



Budget:
- created from previous Q3 forecast and new operational business plans based on strategic direction
- has a horizon of 12 months (fixed) – on monthly buckets
- is backward-looking and provides a detailed snapshot
- is at a ‘planning-unit’ level of detail
- at a level that drives managerial decision-making
- can be compared with actual to maintain cost control
- ensure manager accountability
- level of detail subject to business area volatility (e.g. shared services perform at a higher level than capital project management)

Forecast:
- has a horizon of 48 months (rolling) on 15 month buckets, quarterly to the end of 24 months and then 6 monthly thereafter.
- is forward-looking and corrective
- is at a higher ‘divisional’ level of detail
- is at a level of detail that can be accurately re-forecasted monthly on a timely basis (e.g. typically divisional or similar)
- (from Q3) feeds into next year budget cycle
- includes CAPEX/OPEX

Relevant case studies

Case studies

Qantas — Quality Close and Reporting Review

Client's challenge

- Qantas recognised that performing financial close processes consumed a lengthy period of time and finance resources. They believed that there was capacity to improve and standardise finance processes to generate capacity for finance resources to provide more value adding activities to the CFO.

The journey

- Qantas engaged KPMG to provide an independent high-level review of the current financial close processes. This project allowed Qantas to participate in the KPMG developed 'Financial close e-Survey' which assessed and benchmarked Qantas' current practices against industry better practices.
- The purpose of the engagement was to assist Qantas provide a high level review of the current financial close and reporting processes. We performed and produced the following:
  - Review of the existing close and reporting processes through interviews with key finance staff and stakeholders to assess 'as-is' close processes;
  - Reviewed end-to-end close processes including:
    - Major activities to close
    - Identification of obstacles, barriers, challenges to overcome
  - Conduct Quality Close and Reporting Survey 'Financial Close e-survey;
  - Assess/Benchmark against industry better practices (against over 300 organisations);
  - Discuss Quick Wins with key stakeholders;
  - Observation on future initiatives; and
  - Provide a report containing the results of the survey, high level documentation of the 'as-is' close processes and 'Quick Win' recommendations.

Results

We provided Qantas with a report including:

- Documented 'as-is' close processes;
- Qantas benchmarked against over 300 organisations in 'Financial close e-Survey' report; and
- Recommended Quick Wins and Longer Term Initiatives in a prioritised opportunities matrix.

NYK Line — Quality Close and Reporting Review

Client's challenge

- The Oceanic subsidiary of a major international shipping company used over twenty days to perform their month end financial close. The timeliness of the financial information became a significant issue for both the Corporate and local management. The number of differing financial and administrative systems made resolution more difficult.
- The Quality Closing Project aimed to have each subsidiary submit their monthly financial accounts within three days of month end with a three working day audit clearance.

The journey

- KPMG undertook a three phased approach and performed a feasibility assessment which included developing customised solutions and detailed action plans for each of the entities. This included business process analysis covering both the accounting processes and the related business processes.
- **Phase 1 -** involved a business process analysis covering both the accounting processes and the related business processes. KPMG documented and reviewed the "As Is" process flows and developed "To Be" processes. KPMG interviewed staff, gathered and analysed organisational data, documented existing processes, identified key problems, obstacles and risks, control weaknesses and process inefficiencies, and evaluated the feasibility of implementing the quality-close within the stipulated timeframe. KPMG also developed recommendations for improvement in line with best practice.
- **Phase 2 -** involved the feasibility assessment which included solutions setting and creating detailed action plans for each of the entities. KPMG assisted the client to develop action plans for each entity to implement the methodology in order to achieve a 'quality close'.
- **Phase 3 –** involved assisting management in the project initiation, development of better practice solutions, monitoring and developing feedback mechanisms.

Results

- Management have implemented actions recommended by KPMG in order to achieve a 'quality close'. This reduction in time to complete was achieved with no loss of quality. NYK have reduced their financial close process from twenty days to five working days and has achieved this across all entities. Management are investigating a system solution for more automated and accurate data processing for accounts as recommended to realise further time and control benefits.

Case studies

RailCorp — Budgeting and forecasting review and design

Client's challenge

- The project, Financial Performance and Cost Management (FPCM), was created to address the manner in which this government entity supported all financial activities across the organisation. The client experienced ineffective planning, budgeting and forecasting functions requiring significant manual effort across an extended period with poor resultant accuracy. A critical concept was the alignment of planning, budgeting and forecasting to strategy, and a move to output and outcome-focussed KPI.

The journey

- Phase 1 of the project was a review of the current state assessment to identify opportunities and initial design principles.
- Phase 2 of the project focussed on the conceptual design. This included the sign off of an agreed leading practice framework and design principles
- Phase 3 of the project developed the detailed future state processes and business rules along with detailed functional technology requirements to satisfy the leading-practice framework agreed to in the conceptual design phase. The Detailed Design also provided a clear set of requirements from which detailed implementation plans and business case estimates were established. Significant outcomes were:
  - End-to-end process maps and narratives providing sufficient detail to capture implementation requirements;
  - Clarity of future state roles and responsibilities
  - Early visibility of future state impact to key processes through detailed functional gap assessment; and
  - First draft of tangible and intangible benefits for business case development.
- Phase 4 agreed gaps for implementation and business case completeness.
- Phase 5 of the project was to support the development of implementation plans and associated business case to gain approval for the Build and Implementation phases.

Results

- The KPMG team delivered a conceptual design document followed by an end-to-end detailed design. The FPCM detailed design focuses on the people, processes and technology to provide base data to gain control and visibility over performing planning, budgeting and forecasting, cost management and evaluating and managing financial performance.

NSW Human Services, Ageing, Disability & Home Care — Budgeting and forecasting review and design

Client's challenge

- The chief executive of the State Government agency wanted to improve budgeting and forecasting processes to facilitate enhanced decision-making, as well as to identify opportunities and implement efficiency opportunities to drive forward looking management reporting.

The journey

- KPMG was engaged to assist the client with developing a future state conceptual design, detailed design and a driver based budgeting and forecasting solution. This solution needed to link outcomes to inputs and outputs to aid robust management decision making. The client's existing situation was that desired outcomes were not always linked to inputs and outputs, with strategy development and long-term planning not always translated into the performance management of the team and the individual. In addition, previously developed spreadsheets used to track performance have become outdated and as a result, scarce resources are being utilised to extract and manipulate data into a meaningful form.
- The aim was to improve decision-making and the processes, technology and organisational structure required to support this desired future state. The project involved working closely with the senior finance executives to develop a future state vision after consideration of short- and longer-term alternatives.
- These findings were incorporated into a prototype budgeting and forecasting model to improve the underlying control environment and drive more forward looking budgeting and forecasting resulting in driver based management reporting.
- A prototype financial model was developed as an interim solution to address the gaps within the current tools and processes identified within initial phases, to improve the effectiveness of the budgeting & forecasting and management decision making processes. This model facilitates the determination of the budget for the next financial year and assists management with the implementation of a longer-term strategic budgeting and forecasting tool.

Results

- KPMG developed the high-level business requirements, a future budgeting and forecasting model (based on better practices) and the steps to close the gap from the existing current state model incorporating both short term and longer term initiatives.