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**Public Sector Annual Management Reports
on the Activities for the Financial Year**

*A Discussion Paper on the financial
and related matters that should be covered
by Public Sector Organisation Annual Management Reports*

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1. PRELIMINARY REMARKS

This discussion paper recommends that all public sector organisations should publish an annual management report and suggestions are made about the financial and related contents of such reports on the activities that have occurred during the financial year.

The statutory requirement to prepare an annual management report will depend upon the legal requirements affecting a public sector organisation. Even where there is no legal obligation to prepare an annual management report, in the interests of good corporate governance such a report should be prepared.

The annual management report would be in addition to the annual audited financial statements of the organisation. This discussion paper focuses on the financial and other related information that should be included in the annual management report. Such information would include a commentary about the financial position of the organisation, how this compares with what was expected as set out in the budget, the reason for the main differences, the performance activity together with a range of indicators and measures to identify the efficiency and effectiveness of the organisation. The annual management report should also cover compliance with general legal requirements and with any supplementary requirements imposed on the organisation by the controlling organisation. It also ought to include a statement of the arrangements for corporate governance being followed by the organisation including an assessment of the main financial and operational risks that it needs to address through its internal management and operational processes.

The annual management report ought to be approved by and issued in the name of the governing body of the organisation, whether elected or appointed and signed by its most senior official.

The annual management report is an instrument of accountability and, together with the annual financial statements, conveys information needed by the different stakeholders. Its function is to present, in conjunction with the annual financial statements, the overall position of the organisation for which, in addition to financial aspects, operational, technological, legal and economic perspectives may also be significant.

The information in the annual management report should be consistent with the annual financial statements of the organisation.

Every effort should be made to publicise the existence of the annual management report and how copies might be obtained. The annual management report will be a key accountability statement to stakeholders.

Whether the public sector auditor should review the annual management report to ensure that the financial information it contains is compatible with the financial information contained in the financial statements will depend upon the requirements in a particular jurisdiction. Some auditors in some jurisdictions may also have a specific responsibility to verify performance information published by the organisation.

2. FUNDAMENTALS

The fundamental features of the annual management report are described below.

2.1 *Completeness*

The annual management report should contain all disclosures required for an overall assessment of the financial position of the organisation, its level of operational performance and any factors and risks affecting the future development of the organisation. The disclosures should be sufficient to provide stakeholders¹ with the information they need to make judgements about the performance of the organisation. Therefore, any disclosures, which are material to the presentation of the present and prospective position of the organisation, should be reported.

Management's selection of topics and individual matters to be included in the annual management report should be directed towards their significance to the position of the organisation and to the interests of the organisations stakeholders. Hence, so that full use can be made of the annual management report, more extensive or more detailed disclosures may become necessary, depending upon certain criteria, such as, for example, significant changes that may affect the future operational arrangements. The extent and selection of matters required to be reported, from a materiality perspective, may be influenced by the size, area of activity (e.g. health, cultural, housing), degree of risk and financial position of the organisation. Consequently, where there is, for example, particular pressure on an organisation because of operational circumstances or there are difficult economic times, more comprehensive reporting may be required – particularly with respect to matters affecting future development.

The annual management report should reveal the varying risks and successes of individual segments of the organisation and their respective significance to the entire organisation. Material events impairing comparability between periods should be explained.

Disclosures in the notes to the financial statements are not a substitute for a description in the annual management report unless the financial statements and the annual management report are published as part of the same document when it may be appropriate to refer to relevant financial information through cross references. However, care should be taken to keep such cross references to a minimum in order to avoid confusing the reader.

2.2 *Correctness*

The correctness principle requires that disclosures in the annual management report – even if these are not included among those explicitly required to be disclosed by law – meet the following requirements:

- disclosures of progress and conditions (factual disclosures) are objectively verifiable;

¹ Stakeholders are defined as all those who have an interest in or are affected by the activities of the organisation. Therefore, stakeholders will include the body or individual(s) electing or appointing the board and having responsibility for appraising performance, providers of resources, users of services, employees and the wider community.

- assumptions are credible – i.e. they are plausible and are not inconsistent with the annual financial statements, performance statements, other documents of the organisation and generally known economic facts; and
- conclusions from underlying premises and assumptions are logical i.e. mathematically and factually correct and drawn without bias.

Care should be taken to distinguish between factual observations and conclusions that are drawn from the factual observations.

2.3 *Clarity and intelligibility*

The disclosures in the annual management report should be made in a clear, unambiguous and understandable manner. The disclosures should therefore be neither vague nor excessive, nor should they be qualified in another part of the annual management report. The structure of the annual management report should emphasise, in an intelligible manner, material assertions and significant matters with an appropriate level of detail.

The information included within the annual management report should be consistent with the annual accounts.

The requirement for comparability over a period of time demands that the structure of the annual management report be generally similar to that of the previous year particularly where financial ratios and performance data are included in the report. Comparative data for earlier periods should be included where possible and where provided, should be provided on a consistent basis. Comparisons over a number of years are useful for material financial and performance figures. In the event of a lack of consistency, the comparative figures should be adjusted or sufficiently explained for the purpose of presenting information covering a number of periods. However, comparability should not be used to apply a purely formulaic approach and the annual management report should properly respond to new developments and areas of particular interest to stakeholders.

In the interest of clarity, material matters should be emphasized by using graphical presentations.

2.4 *Publication*

The annual management report should be consistent with the financial statements and ideally should be published along with those financial statements.

Where an audit committee has been established the annual management report should be referred to that committee for its observations which should always be formally considered by the governing body of the organisation before publication.

The organisation in its arrangements for publicity associated with the annual management report needs to recognise that some stakeholders may not always be able to assess the full implications or meaning of the annual management report especially where it contains complex information.

3. CONTENTS OF THE ANNUAL MANAGEMENT REPORT

The annual management report should include, a description of the organisation's activities, the financial position - which should be fairly presented, and a performance statement for the organisation. It should also include a statement about compliance or otherwise with general legal requirements and any specific legal or other requirements imposed by the controlling organisation². The risks, both current and anticipated affecting the operation of the organisation should also be addressed. The annual management report should cover events of special significance occurring after the end of the financial year and the anticipated development of the organisation. Most importantly, the annual management report should also include a statement about the corporate governance arrangements for the organisation.

3.1 *Description of activities*

The description of activities should give an overview of the development of the organisation and any causative events of the reporting period. The description should reveal whether management assesses the development to be favourable or unfavourable.

The factors noted below are material to the description of the activities of the organisation:

Developments in the human, social and/or geographical area of activity

An overview of developments in the area of activity sets a context for the interpretation of matters disclosed in the organisation's annual management report. The annual management report should also include disclosures on the trends in or indications of levels of future public expenditure, grant and taxation or service charge levels to the extent that these are of particular significance to the organisation. This may be especially important in times of recession or restrictions on public expenditure, or inflation.

Demand developments

The development of demands upon the organisation should be described. The reasons for major variances in activity compared to the previous year should be given. Forecasts of anticipated demands should also be given especially where the trends are likely to have a material effect upon the operation of the organisation.

For organisations with long-term contracts and lengthy development lead times, an assessment should be made of how changes are occurring that might affect those long term commitments.

Service delivery

Service delivery reporting includes quantified disclosure of changes compared to the previous year. As part of the description of changes, disclosures are required of new service developments and the impact these will have on the overall development of the organisation including its finances. Changes in service delivery performance (where appropriate set against national or other standards of performance) should be referred to. Furthermore, indications of capacity utilization – particularly of under-capacity – and a description of the effects of

² The controlling organisation for this purpose is defined as the organisation that either appoints the senior officials (e.g. the board), or provides the finance, or exercises legislative or regulatory oversight or in some circumstances it may also include an electorate.

achieved and proposed rationalization of service capacity should be included.

Procurement

To the extent that the organisation is subject to price risks, or quantity (quota) risks arising in material procurement markets, these should be indicated. Material changes to the procurement structure should be explained.

Capital expenditures

New planned capital expenditures, the continuation and completion of expenditures begun and new risks and/or service changes that may affect current capital expenditure programmes should be described. This applies both to expenditures on property and on plant and equipment. The annual management report should also make clear the future revenue consequences of ongoing and future capital investment.

Financing measures and plans

The description of financing should explain the financial management policies, cash flow and where appropriate future borrowing requirements. Where the private sector is financing public services the annual management report should include a statement of how the risk is shared between the private financier and the public sector organisation including a statement of where the ultimate risk would lie if there were a failure by the financier leading to a withdrawal for whatever reason, from the contract.

Personnel and social welfare policies

The reporting on personnel and social welfare policies encompasses disclosures with respect to employees, the structure of personnel expenses, non-statutory social costs, education, training and professional development. Events, which have a particular influence on the organisation, especially material organisation-wide agreements and strikes or other adverse labour relations activities, should be described. (In some countries the remuneration of the senior managers and board members is disclosed and this is a model that other countries may wish to follow in the interests of openness and transparency. However, proposals to do so will need to recognise privacy and data protection constraints that may exist within a particular jurisdiction.)

Environmental protection

Environmental factors (environmental risks, statutory requirements relating to environmental protection) and measures to protect the environment should be explained.

Other major factors during the year

Other major factors, which would impact on the organisation, should also be included.

3.2 Description of the financial position

The annual management report should provide a balanced view of the financial position of the organisation and of its past and future expected operational performance. This requires a balanced description of the position that also takes future developments into account. Where special influences had an effect on financial and operational aspects, these should be described.

The description of the net assets, cash flow, overall financial position and results of operations should be supported by the use of operational performance information and by comparative information both for previous years and for respondent organisation. Additional disclosures may also be needed if the net assets are materially influenced or affected by assets having considerably higher market values compared to the amounts on the balance sheet. Matters not recorded on the balance sheet (e.g. contingent liabilities), which are significant to the description of the net assets, should be explained.

In describing the results of operations, where income and expenditure for the year (and any comparable years identified in the annual management report) is affected by various special factors arising from unusual and extraordinary events, actions taken by the organisation and inflationary effects, which make comparisons with prior years and between organisations difficult, these should be explained.

3.3 Performance Statement

Effective arrangements for corporate governance require that a public sector organisation demonstrates not only its financial performance but also its physical or operational performance. Sometimes what is required to demonstrate such performance is specified by the controlling organisation. However the annual management report should not be confined to such measures but should include all those measures that are material to the effective management of the organisation. Where appropriate the annual management report should also contain appropriate comparative information from previous years, comparisons with appropriate benchmarks and with the performance achieved by equivalent or similar organisations. Any special factors affecting these measures of performance should be properly explained and particular regard should be had to consistency of definition both between years and across different organisations.

Measures used to identify the performance of the organisation, if at all possible, should be independent of the management of the organisation. Where this is not possible this should be made clear in the annual management report.

3.4 Legal Requirements

The annual management report should include a statement about compliance with general legal requirements drawing attention to any material breaches (for example over health and safety regulations). It should also identify any specific legal requirements, regulations or other requirements imposed by the controlling organisation and indicate in the annual management report the extent of compliance with these.

3.5 Disclosures of risks to future development

There are two levels of risk. The first is risk that is inherent to the operation of the organisation and which as a result should be properly addressed in the management and reporting structures of the organisation. An example would be risks to the pollution of the water supply for a water undertaking, failure to care properly for patients in a hospital or for children in a social service organisation responsible for the protection of children. These should always be disclosed in the annual management report together with details of how management are seeking to limit such risks.

The second level of risk is the possibility of unfavourable future developments that are expected with considerable probability. The description of this level of risk should be limited to material risks to future development, that is to those risks which either endanger the ability of the organisation to fulfil its statutory obligations (the 'going concern') or which may have a material effect on the net assets, financial position or performance results of the activities of the organisation.

All organisations should have in place internal control procedures designed to protect against risk as far as possible, or to ensure that areas of risk are properly identified and managed. The annual management report should include a statement about the management of risk and the internal control processes that have been introduced. The annual management report should also comment on the effectiveness of those controls and the process for review. Management should distinguish risks that are more likely to occur, that are material and that are manageable from those that it is unable to control or which are unlikely to occur. Where there has been a breakdown in the internal control processes in the period covered by the annual management report, this should be disclosed together with a statement about the remedial action that has been taken.

3.5.1 Risks inherent to the operation of the organisation

The annual management report should identify those risks, which can be regarded as inherent to the operation of the organisation. Those risks will fall into two categories viz. those which affect the administrative management of the organisation (e.g. catastrophic fire, systems breakdown) and those, which affect the operational activities of the organisation. In identifying these risks the annual management report should also include a statement showing the significance of these risks to the organisation and describe the procedures that it has in place to measure the risk and to protect itself as far as possible against that risk. Where protection is not possible the annual management report should indicate that and explain why.

The influence of external environmental factors (development of the legal and social framework) as well as of operating functional areas (procurement, operation, personnel, financing and capital expenditure) on future development should also be assessed. These areas may be interrelated. If there are bottlenecks within functional service areas (e.g. shortage of doctors or social workers), these may, at a minimum, cause short-term or medium-term disruptions and hence add to risk.

3.5.2 *Risks to ability to continuing to fulfil statutory obligations ('going concern')*³

The question of the continuation of the organisation is of central importance in connection with the obligation to disclose risks to future development. Therefore, a prospective evaluation of the ability of the organisation to continue to fulfil its statutory obligations should be undertaken at each balance sheet date based on the circumstances at that point in time.

To the extent that it may no longer be assumed that the organisation will continue, or to the extent indications exist that continuation of the organisation is endangered, this should be clearly described in the annual management report with reference to the reasons or indications therefore. Even if management ascertains that the facts endangering the continuation of the organisation do not negate the assumption that the organisation will continue to fulfil its statutory obligations at the balance sheet date, the annual management report should indicate such dangers.

The close interrelationship between disclosures with respect to the continuation of the organisation in the annual management report and the recognition and valuation decisions to be taken in the annual financial statements requires that the reporting forecast in the annual management report and the assumption about the ability of the organisation to continue to fulfil its statutory obligation for the annual financial statements should be based on the same reference periods, which would normally be twelve months calculated from the balance sheet date of the financial year as long as there are no sound indications that the assumption that the organisation will continue to fulfil its statutory obligations can no longer be maintained at a point in time thereafter.

3.6 *Important events arising during the financial year*

Events of particular significance arising during the financial year should be identified in the annual management report. Such events would include major changes to the managerial arrangements, major changes to operational agreements with third parties, significant disputes including legal disputes and disputes with employees and events that have changed the basic operations of the organisation such as the closure or extension or addition of major services, or which have changed the operational framework.

3.7 *Events of particular significance subsequent to the end of the financial year*

Events of particular significance that occur after the end of the financial year may effect the position of the reporting organisation and should be referred to in the annual management report. Particular significance should be ascribed to an event if, had it occurred before the end of the financial year, it would have caused a different view to be taken of the position of the organisation. Such events may also be of significance to the continuation of the enterprise. Reporting requirements should be more stringent for those events that have negative effects on the financial position and operational activities of the organisation. The protective function of

³ The concept of the 'going concern' assumption that applies to private sector organisations is not one that is used widely in the public sector except to government business enterprises where accounts are drawn up in accordance with national and internally recognized accounting standards. For public sector organisations a more appropriate, but nonetheless equivalent term is 'ability to continue to fulfil its statutory obligations.'

this requirement should prompt the stakeholders and particularly the controlling organisation to commence timely preventive measures or to make alternative arrangements.

Where the required disclosures cannot be clearly expressed quantitatively, descriptive explanations of the events and their expected effects should be fully provided.

3.8 *Anticipated development*

In the interests of the stakeholders, the forecast of anticipated developments should extend the time horizon to at least two years from the balance sheet date.

Due to the uncertainties of forecasts, disclosures of a single amount or number often convey a false impression of precision. Such uncertainties should be made clear through narrative descriptions (e.g. comparative disclosures on the development of performance) or be made evident by disclosing a range of figures. The annual management report should describe the manner of estimation and the time horizon covered. The annual management report should suitably describe the underlying assumptions upon which forecasts are based and interrelating effects.

The forecast should be prepared with due care based on the judgement of management of the organisation. Overall, the forecast figures and accompanying statements should be realistic and should not be distorted by mere wishful thinking.

3.9 *Research and development (where appropriate)*

The annual management report should cover research and development where the organisation has a systematically planned programme of original research directed towards gaining new scientific or technological knowledge and experience. The annual management report should include a description of the application and exploitation of the result of research or other 'know-how' directed towards the improvement of services. These activities are only required to be reported to the extent they are developed for 'own use' by the organisation.

There would be no reporting requirement for those organisation, which normally do not engage in any research and development activities to any material extent. However, if research and development activities customary in the sector are not carried out, this should be stated.

The explanations should convey to the stakeholders an indication of the overall direction of research and development activities and of their intensity over time. Specific research results arising from individual research projects should not be included in the annual management report.

3.10 The corporate governance arrangements for the organisation

3.10.1 Corporate governance is concerned with structures and processes for decision-making and accountability, controls and behaviour at the top of organisations. The aim is to achieve better quality decision-making and in the public sector better quality service performance for the same input of resources. The arrangements for corporate governance should properly reflect the culture, terminology and specific legal, constitutional and operational environment.

3.10.2 There are three basic principles of corporate governance:

- openness
- integrity and
- accountability.

3.10.3 These fundamental principles ought to be reflected in each of the three ‘dimensions’ of the corporate governance of public service bodies:

- organisational structures and processes:
 - how the top management within organisations is appointed and organised, how its responsibilities are defined, and how it is held accountable;
- financial and performance reporting and internal controls:
 - how the top management of the organisation demonstrates its financial accountability for the stewardship of public money and its performance in the use of resources;
 - how the top management of the organisation demonstrates the effectiveness of the organisation including compliance with targets set for it or by it;
 - the network of various internal controls established by the top management of the organisation to support it in its corporate policymaking role and to oversee operational management;
- standards of behaviour:
 - how the management of the organisation exercises leadership in determining the values of standards of the organisation, which define the culture of the organisation and the behaviour of everyone within it.

The annual management report should describe how these principles of corporate governance have been applied within the organisation and whether any material problems relating to corporate governance have emerged during the period covered by the report.

4. AUDIT OF THE ANNUAL MANAGEMENT REPORT

The information contained in the annual management report should where appropriate be based on the financial information contained in the annual financial statements. The annual management report will also contain considerable operational performance information. In some jurisdictions the external auditor of the public sector organisations may be required to assess the information contained in the annual management report; in other jurisdictions this may not be a requirement. Clearly where there is an independent review by the auditor of the annual management report that adds credibility to the statements contained within that report. However for some auditors this would take them well beyond their current brief.

We therefore make no statement about whether or not the auditor should be expected to comment on the annual management report and its consistency with the annual financial statements of the organisation (although we would be surprised if the auditor, whatever the legal requirements, did not comment if the annual financial statements and the annual management report, when published in the same document, were inconsistent). But we do believe that this is an issue that should be considered in the discussion about the matters that should be included within public sector annual management reports that we hope that this paper will stimulate.