International Consortium on Governmental Financial Management

Working globally with governments, organizations, and individuals, the International Consortium on Governmental Financial Management is dedicated to improving financial management by providing opportunities for professional development and information exchange.

The objectives to achieve the above mission shall include, but not be limited to, the following:

1. Providing, on an international scale, comprehensive professional development activities in the fields of accounting, auditing, budgeting, information systems, cash management, debt administration, and financial management;

2. Contributing to the advancement of government financial management principles and standards, and through educational events, promoting appropriate utilization of government financial methods and techniques to improve management control and accountability to the public;

3. Researching, disseminating, and promoting to its members and to the public throughout the world, knowledge and information concerning government financial management;

4. Promoting the observance of professional standards in the accomplishment of government financial management activities;

5. Sponsoring meetings worldwide in order to educate members and others as to the practice of government financial management as it exists throughout the world; and

6. Bringing together government financial managers from all countries to share information and experiences in government financial management and promoting professional development activities in government financial management.

The Consortium expects to limit the range of the aforementioned activities to governmental financial management disciplines. The following areas constitute the disciplines of governmental financial management: accounting, auditing, budgeting, debt administration, information technology, tax administration and treasury management. These areas provide the general frame of reference for the programs, activities and operations of the Consortium.

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The editor invites submission of articles, research papers, letters and reviews of books and documents. Please submit articles to the editorial office indicated below. Also, requests for information on the Consortium should be addressed to:

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Copies of the Public Fund Digest may be obtained by writing to the address above. The cost is $10 (U.S.) for ICGFM members; $15 (U.S.) for nonmembers. Organization members (shown on inside back cover) are considered members of the Consortium.

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Foreword

We continue to emphasize the Public Fund Digest as a “practitioners’ journal.” Consequently, our lead article is a speech given by the Accounting Director in Hong Kong followed by an article on the experiences in Australia from implementing accrual accounting procedures.

We encourage each of our readers to identify their “best practices” in the financial management of their governments. We will gladly work with these individuals to assist them in reporting their best practices in the Digest so that other governments throughout the world can benefit from their experiences. We are pleased to report three best/better practices: two from the Australian National Audit Office (one on policy advice and the other on contract management) and one from the Office of Economic Co-Operation and Development on budget transparency. If you would like to report your best/better practices, please contact the Publications Editor, Dr. Jesse Hughes, at jhughes@odu.edu for further information or assistance.

We were fortunate to have some excellent presentations at the Fall Summit on Poverty Reduction last November. Three of these presentations (one on EU Accession, another on Improving Public Spending, and a last one on Poverty Reduction Budgets) are included in this issue.

As usual, we invite your comments on these papers and any issue of the Public Fund Digest. Letters to the editor should be addressed to Jesse W. Hughes. Contact us by telephone, facsimile, or on the Internet at www.icfmi.org.

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Impact of Globalization on Government Accounting in Hong Kong

Speech given by Mr. Man-To Shum
Director of Accounting Services, Hong Kong
on the morning of 15 November 2002 at
The 9th IAAER World Congress of Accounting Educators in Hong Kong

Introduction

In the next 15 minutes or so, I will offer my views and experience on the recent developments of governmental accounting on the Hong Kong Special Administrative Region.

Strengths and Weaknesses of Existing Government Accounts

Like most governments in the world, the accounts of the Hong Kong Government are prepared on the cash basis of accounting which, as you are well aware, has the advantage of being straightforward, objective and easily understood by most people—even those without any training or experience in accounting. Most important of all, it offers a simple and effective way for the Government to plan its finance based on what it needs to pay and how much it can raise from various sources; for the legislators to vote funds for different purposes; and for the Administration to manage its budget and subsequent reporting of how much has been spent in accordance with the intent of the legislature.

This, however, does not mean that we are perfectly happy with the cash basis of accounting as a financial planning, monitoring and reporting tool. Quite on the contrary, we find it rather deficient in a number of aspects which are so fundamental that doing nothing to redress them is no longer an option in the wake of an increased level of globalization whereby the emergence of international accounting standards as well as practices overseas have influenced local expectations and demands.

For one thing, it does not reveal the extent of the Government’s obligations in honoring its commitment to pay pension benefits to its employees when they retire. The amount involved, in present value terms, is very significant and yet only the amounts actually paid were reported in the Government Accounts each year. This is very unacceptable—not only from the accounting perspective many of you experts will no doubt testify, but also from an equity point of view—to continue doing this will mean our children and grandchildren have to shoulder the huge burden of paying the pension benefits for the services provided to their fathers and grandfathers. This non-reporting of pension obligations not only understates the Government’s liabilities but also results in the costs for services provided today being understated.

The other thing we find the existing cash-based Government Accounts inadequate is the Accounts report all receipts and payments as income and expenditure respectively. For example, no distinction is made between receipts from borrowing and those from taxes—both are treated as revenue in calculating the surplus or deficit for the particular year in which they are received. Similarly,
moneys lent out are reported as expenditure, so are payments for investments
made and assets acquired.

All in all, the existing cash-based Government Accounts have served the legis-
slative purposes, but we need to give additional, essential information to meet
increasing expectations and demands.

Review of Government Financial Reporting

You may ask—what have we done about it? Well, we established a high-level
in-house Task Force in 1999 to take a close look at the issues involved and to
make recommendations on the way forward to address the issues. In the course
of its study, the Task Force drew reference from the pronouncements and
research results published by local and leading international accounting stan-
dard setters like IFAC and IASC; and the experiences and developments of
overseas countries in government financial reporting. The Task Force fully
understood the need for the Government Accounts of Hong Kong, an interna-
tional financial center, to be at least at par with international best practices in
government financial reporting. This need or desire, however, must not be pur-
sued without due regard given to the very objectives of government financial
reporting themselves in the context of the Hong Kong Special Administrative
Region. Four reporting objectives have been identified:

• First, the accounts must be able to demonstrate budget compliance. In Hong
Kong, the Legislative Council approves the Government’s annual budget in
terms of both scope and amounts—i.e. for what purposes and by how much
—through a piece of legislation each year. The existing cash-based
Government Accounts are prepared mainly to report back to the Legislative
Council on the actual outturns vis-à-vis the approved budget after the end of
a financial year.

• Second, the accounts should report fairly on the Government’s financial per-
formance and position. As I have mentioned earlier, the existing cash-based
Government Accounts are clearly deficient in this aspect.

• Third, information should be provided to facilitate planning, informed deci-
sion-making, and subsequent monitoring and evaluation so that public serv-
cices can be delivered efficiently and effectively. Owing to the high-level
nature of annual Government Accounts, it may be asking too much for such
detailed information to be made available that is often required at more fre-
quent intervals during a financial year. The financial reporting regime, how-
ever, should engender the easy production of this kind of information
through the establishment of the relevant financial reporting framework.

• Fourth, the Government should be accountable for the scarce resources
entrusted to it by the citizenry. By accountable we mean the Government
should provide information on how much is in its custody and what it has
done about it—particularly in respect of the changes that may not have been
easily discerned from the accounts. In the case of the Hong Kong
Government, the scarce resources entrusted to it consist primarily of land and
we find financial accounting may not provide the best way for the
Government to discharge its responsibility in this respect.

Review Results and Changes

Except for the first objective, the Task Force found the existing financial
reporting regime of the Hong Kong Special Administrative Region wanting in
respect of all the three other objectives. To achieve substantive improvement under the existing tight budget climate, the Task Force made a number of recommendations and the major ones are:

- First, the existing cash-based accounts will continue to be prepared in view of the need to demonstrate budget compliance.

- Second, in addition to the cash-based accounts, a set of accrual-based consolidated financial statements will be prepared, starting with the financial year for 2002-03, to report fairly the Government’s overall financial performance and position. The accrual-based consolidated financial statements represent a significant improvement over the existing cash-based accounts in a number of aspects. Not only will major assets and liabilities be reported which means the Government’s revenue and expenditure will be calculated on a more rational footing, but also a number of government funds and authorities currently not included in the accounts will be consolidated—for example, the Exchange Fund and the Housing Authority. Realizing the impact of reporting fixed assets in the accounts, the Task Force also recommended the sums represented by fixed assets, which are no more than past expenditure, to be designated as Capital Expenditure Reserve so as to avoid possible confusion as to the amount of funds that can be applied in the future. The amount of financial resources available, being the excess of financial assets over liabilities, will be designated as the General Reserve.

- Third, a Stewardship Statement is published to give non-financial information as to the quantities of major resources employed by the Government in service delivery—these include land, buildings, and infrastructure assets such as roads and drains.

In addition, the Task Force also recommended an evolutionary, rather than a revolutionary, approach taking into account the local situations such that there will be some deviations from the accounting standards issued by IFAC.

- First, the Government’s fixed assets will not be reported initially pending the completion of an identification and valuation exercise to be completed in 2004-05.

- Second, infrastructure assets that do not generate revenue, such as roads and drainage system, will not be reported as fixed assets because, in Hong Kong, these non-revenue generating infrastructure assets do increase the values of the land made available for sale. As the land sale proceeds are fully recognized as revenue in the year the proceeds are received, it appears rather inconsistent to amortize the relevant costs over time.

- Third, except for expenditures that will give rise to material liabilities such as pensions, accrual will not be made for revenue and expenditure in general. The nature of most revenue and expenditure of the Government of the Hong Kong Special Administrative Region is such that either there are no accruals involved or the amounts in question will not be material. On the other hand, the efforts required to ascertain the amounts involved will be quite substantial considering that the financial management information systems in use do not support accrual. As we are now in the process of replacing the existing information systems with systems that will facilitate the preparation of accrual accounts, we will revisit this issue after the requisite systems are in place.

- Fourth, certain entities will not be consolidated or consolidated on an equity basis instead of a line-by-line basis as required by the accounting standard issued by IFAC. This non-compliance of accounting standard is made primarily out of the need to reflect the actual relationships between the
Government of the Hong Kong Special Administrative Region with these individual entities. The relationships are, more often than not, either one of that between a supplier and provider of service, or that between an investor and investee, rather than forming part of the Government’s operations on which the accounts should be focused and will probably be obscured if all these entities are consolidated on a line-by-line basis.

Public Consultation and the Way Forward

According to the views and comments received from the public through a consultation exercise conducted last year about the Task Force’s findings and recommendations, there has been a general consensus about the Government’s move towards accrual accounting, but some people are quite critical of the departures from the accounting standards, although some are of the view that the Government should progress at its own pace towards the eventual goal of standard compliance. The Government accepts it as a longer-term goal to prepare a set of accrual-based accounts that conform with the applicable international accounting standards as far as possible having regard to local situations. In fact, it is intended to carry out a post-implementation review in 2006-07 to identify the scope and opportunities for further compliance. The review will also take stock of the results achieved and explore the appropriateness for the Government to adopt accrual-based budgeting.

Conclusion

It cannot be said that the impending improvements to the Government Accounts of the Hong Kong Special Administrative Region are attributable to an increased level of globalization in governmental accounting as manifested in the emergence of IFAC and the moves made by some developed countries towards accrual accounting in recent years. However, these developments certainly have an impact on the way in which we go about addressing the deficiencies of existing governmental accounting. In conclusion, I must stress that the overriding objective is to report fairly the Government’s financial performance and position, rather than conformity with international accounting standards.
Executive Summary

The landscape of public sector financial management has been constantly changing over the past decade. In 1997 the Commonwealth Management Advisory Board (MAR) undertook a benchmarking study of how the Commonwealth public sector was positioned in terms of better practice financial management compared to other public sector agencies and the private sector. At the time of the original MAR report, the Commonwealth public sector was considered to be lagging behind the practices of the private sector and the rest of the Australian public sector.

Almost three years on, CPA Australia, with the support of the Commonwealth, commissioned Beyond Bean Counting 2000: A Benchmark of Effective Financial Management in the Australian Public Sector.

Beyond Bean Counting 2000 examines the progress of the public sector agencies across the three tiers of government in their work to achieve better practice financial management. The survey revisits many of the topics raised in the 1997 MAR report, attempting to capture the effects of the widespread public sector financial management reform that has taken place over the past three years.

Clearly, one of the key dimensions of better practice has been achieved since 1997, with the adoption of accrual financial management and output/outcome based accrual budgeting by most jurisdictions.

Twenty-five organisations participated in the 2000 survey, covering the three tiers of the public sector and one private sector organisation. Separate questionnaires were sent to both the Chief Executive Officer (CEO) and the Chief Finance Officer (CFO) of participating organisations.

While the size of the sample is smaller than the 1997 survey the content and areas covered are similar and are a basis for data comparisons. However, as with all surveys some variations can occur, so appropriate caution is needed when interpreting the results. Overall comparison with the 1997 results show some clear trends.

It is clear that by embracing a culture, which places greater emphasis on financial management skills, the public sector has precipitated some noticeable shifts in organisational behaviour. Some of the more significant trends have included:

- A widespread acceptance of the value of accrual information by CEOs
- CEOs and CFOs are taking a more dominant role and accountability for financial results
- Continuing strong demands for qualified accounting and finance professionals
- The emergence of revenue and profit/loss targets in the annual budget in place of a focus only on expenditure
- A significant change in the budgetary control function
The widespread use of integrated financial management systems assisting the devolution of financial management authority to line managers

A significant shift in the main focus of internal management accountability from individual budget line items (e.g. travel, salaries, etc) towards a focus on financial results (operating result, key ratios).

The results of the 2000 survey show that substantial progress has been made by the public sector in relation to financial management since 1997, with evidence of significant cultural and behavioural shifts. It must be recognised that to a large degree no other industry sector has undergone such radical shifts in the way it operates as the public sector has with financial management reform. Notwithstanding these considerable advances, there is still substantial scope for further improvement, specifically:

- Many organisations are yet to move away from cash-based data as their source of information for internal decision-making
- Many organisations continue to operate systems in a dual cash and accrual format
- Financial management skill levels of line managers are perceived as lower today than they were in 1997
- Despite the development of various financial management incentives to encourage more desirable financial management practices, some of the most rudimentary ones have not been widely implemented.

The changing dynamics of the public sector will necessitate that agencies continue to embed the better practice financial management frameworks and utilise the new tools and information available to them.

1. The Australian Public Sector Three Years On

Introduction

*Beyond Bean Counting 2000* examines the progress of financial management practice across the Australian Public Sector (APS), Commonwealth, state and local government levels in the three years since the 1997 landmark study — Beyond Bean Counting was conducted by the Commonwealth Management Advisory Board (MAB).

The MAB report was produced at a time when significant changes were occurring in public sector financial management practice across Australia. At this time, the degree of change varied across all jurisdictions with a few pioneering jurisdictions already implementing substantial changes to their financial management frameworks. Others were just beginning to develop their reform programs.

The catalyst for change had come from many areas. Developments in public sector accrual accounting had been pioneered in New South Wales and New Zealand during the late 1980s and this had a significant influence on the direction of financial management across the APS. The development of new accounting standards that specified the format and nature of public sector external reports also gave a strong impetus for financial management reform. Following changes of government, several jurisdictions set up independent Audit Commissions whose reports strongly advocated financial management reform. These and other influences had a significant effect on the course of events prior to the publication of the MAB report.

The story ‘three years on’ illustrates the considerable change with most of the
APS now having implemented substantial change, particularly in relation to budget and accounting methodology. The 2000 survey adopted a similar approach to the original MAR survey to help show the impact of the reforms on the financial management of key APS agencies over the past three years. This section looks in detail at the changes to financial management practice, during the past three years, and identifies future issues that must be addressed by the sector.

A snapshot of the APS—recent trends

In 1997, state and local governments, particularly Victoria, South Australia and the Australian Capital Territory (ACT), were leading financial management reform in the APS. Since then, several other jurisdictions have implemented financial management reform programs, including Queensland, Western Australia and the Commonwealth. Tasmania is the latest jurisdiction to commit itself to an accrual based budgetary and accounting framework, commencing in July 2001.

The implementation of accrual based financial management reform has been the catalyst for a range of other key initiatives recently undertaken by the public sector. A summary of key changes that have happened in a number of the jurisdictions are discussed in this section, including:

- A clear shift by most jurisdictions from input to output based budgets, with some now moving towards an outcomes framework
- The increasing pace and extent to which all levels of the public sector have turned to market testing and outsourcing of ‘non core’ public sector activities including, corporate services and financial management functions
- The greater emphasis of the ACT Government to link appropriations to comparative market prices
- The linking of agency revenue with an assessment of output delivery by Victoria and Western Australia
- The move by the Commonwealth Department of Finance and Administration to undertake a series of ‘pricing reviews’ using benchmarking techniques to test the reasonableness of agency output prices
- The evolution of performance measurement and management by the APS, using a balanced scorecard approach
- The Commonwealth and state public sectors recognising the importance of ownership management
- The separation of the role of purchaser/provider in APS organizations
- The development of strategic service procurement in Victoria
- Continued changes to financial management legislation
- The development of shared service centres for the provision of corporate service functions on a competitive basis
- The continued adoption of Compulsory Competitive Tendering principles by local government and more recently Victoria’s adoption of Best Value principles.
- These initiatives are described in greater detail below.

Outputs and outcomes

Most jurisdictions have moved or are in the process of moving to accrual output or outcome based budgets. The move to outputs has facilitated a greater understanding by government and the broader community of what is actually
being purchased by government and what are the minimum specifications that
the purchaser should expect upon delivery of the output. Some jurisdictions are
now moving from outputs to outcomes. This will be a challenging component
to public sector financial management reform as the sector grapples with how it
can quantify and measure its achievement of the desired outcomes.

**Market testing and outsourcing of corporate services**

The Commonwealth Government has requested that all departments
undertake market testing of their corporate service functions during the
2000/01 financial year where this has not previously occurred.

In this process, Commonwealth departments are examining the possible
outsourcing of corporate services, including all accounting functions, covering
the transaction processing and management accounting activities.

General trends in the public sector indicate that activities currently being
contracted include budget preparation, financial reporting (monthly and annu-
ally) and some processing activities. It is anticipated that outsourcing corporate
services will accelerate over time as the market testing activities identify the
capacity of the market place to undertake these responsibilities in a partnership
arrangement.

Numerous Commonwealth departments have already outsourced internal
audit and payroll services. This process has also been occurring throughout
state public and local government sectors.

**Comparative market pricing**

The ACT Government has been developing an appropriation regime whereby
the price appropriated to an agency for the purchase of its outputs is based on a
market price. The market price is established by applying a series of benchmark
comparisons with similar organisations performing similar functions. In some
cases, Commonwealth Grants Commission data has been used to form the com-
parative basis. Once the market price has been established, this sets the output
price to be appropriated to the agency. Any shortfall between this and the full
cost of service provision is funded separately as a capital injection in order to
highlight any inefficiency in service delivery on the part of the agency.

**Pricing reviews**

The Commonwealth Government has decided to implement pricing reviews
for a limited number of departments following the introduction of the
1999/2000 accrual based outcome/output budget. These reviews are designed
to examine the price of outputs/outcomes with a view to identifying the reason-
ableness of those prices. In essence the task is to identify the cost base (which is
essentially the figure used as the price on many of the outputs) and to draw
benchmark comparisons where possible. The reviews have been largely con-
ducted by departments with support and advice from the Department of
Finance and Administration.

These pricing reviews have typically examined a selection of outputs
although in some instances all outputs have been examined. The task for
departments is to continue this process of examining output prices during the
2000/2001 financial year.

The information generated from those reviews is a further basis for develop-
ning budgets, particularly for the forward years 2001/2002 and beyond.

**Revenue recognition**

Revenue recognition is another approach that is being trialed, particularly in
Victoria and Western Australia. It involves determining the extent to which agencies have delivered their outputs during a specified period and allowing them to recognise revenue accordingly. Where there has been a shortfall in the delivery of outputs or over-delivery compared with budget, revenue may be adjusted downward or upward to reflect this position. The intention of revenue recognition is to make service delivery more visible, and to prevent an apparent operating surplus from arising simply because an agency reduces operating costs as a result of failing to meet its agreed budgeted output level.

**Performance management**

The adoption of accrual financial management, the full costing of goods and services and the establishment of the output/outcome based frameworks coupled with the desire to more accurately establish a price base for outputs/outcomes has accentuated the need for improved performance measurement. These initiatives became the catalyst for all tiers of government to develop robust performance measures to capture quantitative and qualitative elements for the goods and services delivered. In the early stages of these reforms there was an increased focus on cost, however, this should only be seen as one element used to measure the efficiency and effectiveness of public goods and service delivery. In this regard, emphasis is now being placed on the measurement of outputs through mechanisms such as the balanced business scorecard. These mechanisms are being adopted to give management a better way of identifying achievements against ‘targets’ and to create real linkages to the planning cycle.

Prior to the current initiatives, the linkages between the planning cycle (which have been in place in most departments for a number of years) and the budget process have been rather tenuous. Typically, the two existed as separate management initiatives, with little or no linkage, except perhaps during the reporting processes where annual reports attempted to draw some parallels.

With the introduction of the accrual based output/outcome initiatives the performance measurement practices are integral to the budget process and therefore the planning cycle which articulates goals, objectives and establishes key performance indicators.

The need for performance measures that are achievable and measurable, has been reinforced by some jurisdictions by having them audited as part of the annual financial statement audit process.

**Ownership management**

Many governments are acknowledging their dual interest in agencies as both a purchaser of services from agencies and also as an owner of agencies. An ownership-monitoring role protects the government’s ownership interest in its agencies and aims to ensure the government receives an appropriate return from the resources allocated to the agency. This is done through monitoring the efficiency and financial performance of the department and the exposure to financial risk. The government, as owner, has the right to make resource allocation decisions in the form of equity injections and withdrawals to agencies. As an increasing proportion of jurisdictions have moved to corporatise public entities, the resulting balance sheet management issues and value of the ‘owner’s equity’ will now be closely monitored by resource managers. Some jurisdictions are seriously pursuing this approach, although, it is an area that is still under development.
Purchaser/provider

There has been a significant trend across jurisdictions to establish purchaser/provider relationships within and between government departments. The intention of a purchaser/provider arrangement is to create an internal market to provide clear resource allocation signals. Typically, this is done to avoid the ‘free-good’ syndrome, where the consumer of a service has no budget and has to accept whatever service level the provider decides. A purchaser/provider split empowers service recipients to specify what they want to purchase and the quantity, quality and related price that they are prepared to pay. In turn, the provider can respond to market signals to deliver an appropriate level of service for the price being offered. Purchaser/provider separation has been trialed in various parts of the public sector, in particular the health sector.

Strategic service procurement

Strategic service procurement (SSP) is an initiative developed by the Victorian public sector to streamline and improve the departmental procurement process. It is closely aligned to many of the other financial management reform activities being implemented. In Victoria, a Tender Board traditionally approves the tendering of major contracts by departments. Under SSP principles, departments are encouraged to achieve accreditation levels (through proven skill development) entitling them to enter into contracts up to a given value without reference to a Tender Board. Thus, the approval process occurs at the front end (through accreditation) rather than at the rear end (Tender Board endorsement). This process can be applied to the outsourcing of inputs or to the purchase of final departmental outputs. The process is streamlined to the benefit of suppliers and departmental management.

Legislative change

Over recent years most jurisdictions have continued to reform the legislation that support their financial management frameworks. Victoria only recently amended their Financial Management Act 1994 and the Audit Act 1994 to enhance the levels of disclosure by the Victorian Government in relation to financial and budget information. The changes to the Audit Act now provide for review of the estimated financial statements within the Victorian State Budget by the Victorian Auditor-General. Ongoing changes to the various jurisdictions financial management legislation may be needed to sustain those jurisdictions financial management reform agendas.

Shared service centers

The concept of providing corporate services on a market basis to multiple agencies is being trialed in various jurisdictions. Potential benefits to user agencies and to government include economies of scale in the provision of these services, more responsiveness by the provider, lower cost to government and greater control by the purchasing agencies.

The future

Although the public sector in Australia has continued to undergo significant financial management reform, there are constantly new issues on the horizon that need to be considered. Some of these major issues are discussed in the remainder of this section.

The ‘E’ industry

E-Business, E-Commerce and E-Procurement are going to have enormous impact on the way the public sector does business in the future. Governments in a number of jurisdictions want services available on line by a specified date.
This will significantly affect the finance function of the agencies involved

**Corporate governance**

The recent changes to the financial management frameworks of the public sector have increased the focus on corporate governance. The implementation of robust corporate governance frameworks that support the new financial management frameworks will become an imperative for management in public sector agencies. However, these governance frameworks will need to strike a balance between the freedom to manage, established under the financial management reform frameworks, and the legitimate interest of different stakeholders.

**Increasing international focus**

The international arena is continuing to push for better practice financial management. Organisations like the International Federation of Accountants (IFAC) are developing better practice international standards in financial reporting by governments. As such the public sector needs to be constantly monitoring changes that are occurring in the international arena.

**The changing structure of the public sector**

Central to public administration in the future is the continued involvement of the private sector in the delivery of goods and services, outsourcing and contract management and contract assessment. The financial management function in many public sector organisations will need to be in a position to advise government as it explores the various options for the delivery of goods and services. The finance function will continue to be required to advise the government on whether best value for money is being achieved and quality levels are being sustained under the current service delivery model. In particular, performance management will continue to play a pivotal role in successfully managing the contract relationship with the private sector.

**2. Key Australian Public Sector Agencies Benchmarked**

This section outlines the background to the survey, factors influencing the results, the results and the key conclusions.

**Background**

**Comparisons with Beyond Bean Counting**

One of the main objectives in conducting this survey has been to analyse the aspects of financial management that have changed since the original survey was conducted for Beyond Bean Counting in 1997. The 2000 survey revisited many of the issues raised in the 1997 report and the results have been interesting.

As with most benchmarking exercises, the greatest value often comes from the ability to track trends over time. With this in mind, CPA Australia approached the Commonwealth to undertake an independent review of the financial management function three years on from its 1997 MAB report. With the support of the Commonwealth, CPA Australia commenced Beyond Bean Counting 2000. Prior to this, a number of federal and state chief finance officers had met informally to discuss initiatives and to further the aim of improving financial management within government. However, there had been no formal review of the public sector’s progress since the original MAR report.

CPA Australia undertook this survey in the interest of supporting and informing all governments and public sector managers of the successes to date, as they progress with these significant and fundamental changes to their finance and management structures. CPA Australia would encourage all managers and
organisations in the public sector to be involved in future studies.

The principal aim of this study was to identify the trends in financial practice across a number of key agencies, within the Commonwealth, state and local government sectors. It included information on:

- The day to day operations of the accounting function
- The structural and management approaches being adopted
- The accountability frameworks within which the financial management functions are established, particularly for reporting mechanisms
- The extent of professionally qualified staff supporting the finance functions within these organisations.

In addition, a detailed benchmarking study of each participating agency’s finance function was undertaken at the same time, which provided them with an individual benchmarking report on their functional efficiency.

Factors influencing the survey results

Twenty-five organisations participated in the survey, covering key agencies from Commonwealth, state and local government and the private sectors. Separate questionnaires were sent to both the CEO and the CEO from organisations participating in the survey.

Compared to the 1997 survey the sample size is smaller, but the cross section of organisations is similar and includes participants in the original survey. The 1997 results have been used as a basis for comparison. Some caution is needed to avoid distortion of the findings due to the differing sample sizes between surveys. In addition a number of agencies that volunteered to participate in the survey were actively pursuing better ‘practice’ status, which could increase the standard of response above the average. Despite these concerns, the results do show some clear and valid trends.

CPA Australia expects that this survey will lead to ongoing studies. It is anticipate that in the future a larger sample will be used to avoid any distortions that may result from a smaller sample size.

Structure of the survey

The survey was structured as one discreet set of questions for CEOs and one set for CEOs. The surveys were based on the CEO and CFO questionnaires that had been used in the 1997 MAB report. The intention was to obtain two separate perspectives on financial management progress in the agencies.

Response to Survey

Of the 25 organisations that responded, 20 organisations completed the CEO survey and 24 completed the CFO survey. The composition of agencies that responded included:

- 10 State and territory departments
- 12 Federal Government departments
- 1 Private sector organization
- 1 New Zealand department
- 1 Local Government agency.
Survey results

Chief Executive Officer Survey

The survey of CEOs focused on three main areas:

• The importance of achieving financial results as part of the CEOs overall responsibilities
• The usefulness of the financial information produced by the organization
• The financial management competence of line management and the OFO within the organisation.

The importance of achieving financial results as part of the CEO’s overall responsibilities

The survey confirms the widely held view that financial performance of an organisation is becoming increasingly important to the public sector CEOs; an attitude which has long been commonplace in the private sector.

In the 2000 survey, 85% of CEOs agreed that achieving budgeted financial results for controlled items was one of the three main indicators of their personal success (up from 81% in 1997).

Interestingly, 65% of CEOs acknowledged that the achievement of budgeted financial results for administered items (those items such as grants or welfare payments over which they do not have direct management control) would also be one of the three main indicators of their personal success. While this question was not surveyed in 1997, it is notable that such a significant number now regard this as an important part of their responsibility.

The CEOs concern for their respective agency’s financial performance is also reflected in the amount of time that CEOs appear to devote to dealing with financial management issues. In the 2000 survey, 80% of CEOs said they devoted over 10% of their time to financial management issues, up from 58% in 1997.

The usefulness of the financial information produced by the organisation

The value of accrual information is also more highly regarded by CEOs today than it was in 1997. In the 2000 survey, 95% of CEOs who used accrual information for decision making found it ‘reasonably or extremely useful’, compared with only 65% back in 1997. This result would seem to be consistent with the more widespread adoption of accrual accounting across most Australian jurisdictions over the last three years and acceptance by CEOs of accrual information as a useful decision-making tool.

The financial management competence of line management and CFO within the organisation

Perhaps one of the most interesting results of the CEO survey has been the change in perception of the skill levels of line management in the finance function. In 1997, when many of those surveyed were still operating in a cash accounting environment, 79% of CEOs rated the financial management skills of their line managers as either ‘very good’ or ‘excellent’. This compares with only 15% of CEOs holding a favourable opinion in 2000.

This most probably reflects the growing complexity of the activities associated with financial management in an accrual environment and recognises that there is clearly a learning curve which line managers must go through to adapt to that new environment. The 2000 survey reinforces and highlights that 85% of CEOs believed that the financial management skills of their line managers needed to improve in order to meet future organisational needs, compared with only 64% holding that view in 1997.
In contrast, the finance skills of CFOs, as assessed by their CEOs, seem to be highly regarded in the 2000 survey, with 95% of CFOs having their skills rated as either very ‘good’ or ‘excellent’. This may well be linked to the increasing proportion of professionally qualified finance staff holding the senior finance position in government departments.

**Chief Finance Officer Survey**

The CFO survey focused on nine major financial management areas:

- The use of accrual information
- Internal and external reporting processes and use of financial information
- Financial management incentives available to the organization
- The key financial management features of the organization
- The use of accounting systems to support financial management
- Capital investment processes
- Finance skills within the organization
- Balance sheet management issues.

The changing nature of the finance function, as a result of the financial management reforms that have been widely implemented across the APS, is clearly evident in many of the survey responses. All of the organisations surveyed (public and private) now operate under a contemporary style of financial management, with extensive use of accrual information for both budgeting and accounting purposes.

As the financial management environment has become more complex, there has been significant effort and attention on training staff to operate in the new environment. However, the survey suggests that this training is not yet effective, with significantly lower levels of satisfaction about the financial management skills of line managers today than in 1997.

This result strongly suggests that implementing a new financial management framework across Government is not, by itself, going to be sufficient to change the way that financial management is practised in the public sector. Clearly, a concerted training and development effort combined with sufficient time for staff to learn the necessary skills will be critical before any substantial and sustainable change is evident.

**Use of accrual information**

The adoption of accrual information for budgeting, reporting and decision making purposes has been widespread across the APS. In 1997, 78% of organisations surveyed received a budget appropriation on a cash basis. The 2000 survey revealed a major drop, with only 17% continuing to use this system.

Some organisations, however, still appear to be reluctant to move completely to an accrual management framework. The 2000 survey highlighted that 26% of organisations still used a combination of cash and accrual methods for allocating their budget internally.

The reliance on cash based information was highlighted further with 39% of organisations indicating that they reported both cash and accrual figures internally and 57% of organisations run accounting systems that produce both cash and accrual reports.

Cash remains an integral part of the accrual management framework however, it is only one component and needs to be managed in conjunction with other resources in the organisation.
In recording transactions (both controlled and administered revenues and expenses) it is noteworthy that no organisation used exclusively cash accounting for this purpose in 2000. The comparative statistics from 1997 ranged between 32% and 35%. So while all organisations in the current survey were ‘accrual accounting capable’, it is significant that a fair proportion are still using cash information as the supplementary (if not, indeed as the primary source of information).

**Budgeting and the budget preparation process**

The important role of budgeting in the financial management process is emphasised by the amount of time devoted by organisations to this task. The ‘Budget’ is still a pivotal statement of resource allocation for all jurisdictions. The survey highlights that 26% of organisations spend five months or more preparing their external budget, while a further 26% spent three to four months on this task. There have been significant changes in the basis of funding for public sector organisations, with 63% reporting that they are funded for outputs and 15% reporting they are funded for outcomes. Only 11% reported that they were funded for programs, and none said their funding was based on inputs.

The impact of budget reform across government jurisdictions is quite pronounced, as in 1997, 40% of those surveyed were funded for programs and 25% for inputs.

Agencies appeared to be spending less time on the preparation and management of internal budgets compared to the times spent on the external budget. However, most agencies stated that internal budget management still consumed a significant amount of time. Only 4% reported completing the process within one month, 69% took between one and three months with the remaining 26% taking more than three months.

Another interesting feature about the public sector’s adoption of new financial management principles lies in the emergence of revenue and profit/loss targets in the annual budget. The survey showed that 96% of organisations had a sales/revenue budget and a budgeted profit/loss target in 2000 (up from 34% in 1997).

However, the demands of the budgeting process are increasingly being seen as a drain on an organisation’s resources and a constraint on its ability to react quickly to changing circumstances. There is a growing trend among private sector organisations towards reducing the impact of the budget on corporate activities, while in government the budget is becoming more comprehensive in its coverage. In the 2000 survey, 96% of organisations prepared budgets for three or more years ahead.

**Internal and external reporting processes and use of financial information**

It has been noted that accrual information is used as the basis of both external and internal reporting by APS agencies. The 2000 survey also revealed a number of other interesting features of internal and external reports in the APS.

The 2000 survey highlighted that 75% of organisations report monthly financial results against a planned profile, while only 17% report against a pro-rata budget, suggesting that there is a reasonable degree of sophistication being built into the budget setting and performance measurement process. There is also an increasing use of non-financial performance measures in financial reports, with 57% of respondents using them in 2000, compared with 53% in 1997.

It appears that monthly internal reporting has become the norm, with 100% of those surveyed in 2000 reporting on a monthly basis (up from 90% in 1997). Many organisations appear to put a high priority on the timeliness of reporting,
with 48% of the 2000 survey respondents producing internal reports in five days or less.

Financial management incentives available to the organisation

The widespread introduction of financial management reform across the APS since 1997 has led to significant changes designed to encourage more appropriate financial management behaviour at the agency level. The survey identified that 57% of organisations could retain the proceeds of an operating surplus (up from 44% in 1997).

The 2000 survey illustrated that 96% of organisations can sell assets and retain the proceeds (up from 78% in 1997). A further 83% of organisations reported that they could retain interest earnings on their bank accounts (up from 49% in 1997) and 70% reported that they could borrow debt capital from their Department of Treasury/Finance or finance corporations (up from 50% in 1997).

By giving CFOs and CEOs greater responsibility and accountability for how they manage their resources and allowing them to access the rewards of good financial management practices positive behaviours will follow. Through the fostering of such behaviour the traditional tendency to spend to the limit of their appropriation (in order to avoid forfeiting unexpended funds at year-end) will be a thing of the past.

Some agencies are being encouraged to actively seek alternative means of generating funds, by removing some of the disincentives that have stood in the way in the past. One such change includes allowing agencies to retain the proceeds of asset sales, which in the past may have contributed significantly to the accumulation of underutilised assets in the public sector.

In numerous cases, the structural changes have been augmented with personal incentives, which can encourage managers to use the newfound financial freedoms. The survey showed that 52% of APS executives reported receiving personal incentives linked to good or favourable results.

The full effect of the implementation of incentives as a reward to bring about changes in management behaviour is yet to be fully seen or quantified. However, there is a large expectation in the public sector that such incentives will, over time, lead to an improvement in the way in which the public sector’s financial management frameworks operate. As Allen Schick observed in relation to similar reforms in New Zealand:

‘the New Zealand reforms are utterly dependent on robust, entrepreneurial, risk-taking managers.... Without strong management, New Zealand departments would be about the same after reform as they were before, but with high transaction costs and greater risk to government’. (Prof. Allen Schick, The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change, State Services Commission & Treasury, Wellington, August 1996).

The key financial management features of the organisation

While many of the financial management features identified in the 2000 survey are a direct consequence of the reforms to the public sector financial frameworks, some features have been directly influenced by the individual management style present in the organisation. Interestingly, two opposing trends can be observed when analysing who takes responsibility for financial management issues within an organisation.

The results suggest that since the 1997 survey, both the CEO and the CFO have taken on a more dominant role so far as overall responsibility for financial
results is concerned, with 67% of organisations reporting that the CEO/Deputy CEO had overall responsibility for financial results (up from 62% in 1997) while 20% of organisations reported that the CFO was responsible (up from 15% in 1997).

Conversely, the budget responsibility has become more devolved, with only 15% of organisations reporting that budget responsibility rests with the CEO/Deputy CEO (down from 18% in 1997), while 48% reported that line managers now have budget responsibility (up from 43% in 1997).

The tendency to devolve certain aspects of financial management away from the CEO/CFO to lower levels within the organisation was clearly illustrated in the responses to the survey. Since 1997, the number of organisations where the CEO is responsible for the internal assessment and allocation of budget bids has fallen from 49% to 42% and for the CFO from 23% to 8%.

It appears that line managers are given a more active role in the budgetary control function. The survey highlighted that 88% of organisations rely on managers using internal reports and variances to control expense budgets (up from 67% in 1997). It was pleasing to see that of the organisations surveyed, none are still using warrant controls or similar external controls (33% were in 1997).

The use of accounting systems to support financial management

Accounting systems are an important enabler to any effective financial management framework. Substantial investments have been made by many public sector organisations over the past three years in this area.

At the time of the 2000 survey, virtually all the organisations surveyed were operating an integrated financial management system (96% compared to 86% in 1997). These systems were also assisting in the devolution of financial management authority to line managers, with 78% of managers now able to run reports directly from the financial management information system (up from 66% in 1997). The use of additional reporting tools has become widespread, with 78% of organisations surveyed in 2000 saying they use executive information systems or other software packages to produce financial reports.

Another feature of contemporary accounting systems, which may be underpinning the greater devolution of financial management in organisations, is the move away from centralised data input. In 1997, 53% of organisations surveyed used centralised data input for the bulk of transactions. At the time of the 2000 survey, this had dropped to 39%. The better communication systems in place today have made it more efficient to manage financial issues closer to the point of original activity, rather than relying on the traditional economies of scale available through centralisation.

Perhaps the most interesting feature of contemporary accounting systems is not how the data is created, but how it is used. A significant shift has taken place in management behaviour since the previous survey, where 65% of respondents saw the main focus of internal accountability to be against individual budget line’ items (e.g. travel, salaries, etc). By 2000 that had declined to 39%, with 61% of organisations now focusing internal accountability on financial results (operating result, key ratios).

This suggests that managers are being given greater financial management authority to deliver a ‘bottom line’ result, instead of the traditional public sector emphasis on controlling expenditure on a line by line basis.
Capital investment processes

One of the most significant changes brought about by the financial management reform program has been in the ability of public sector organisations to access funding for capital items.

Previously, in most jurisdictions, access to capital funds (with the exception of ‘minor works’) had required capital appropriation, even when the funds were simply to replace an existing worn out asset. Today, many public sector organisations are funded for the depreciation element of their operating expenses as part of an output appropriation, leaving only new asset requirements to be accessed via capital (increase to net assets) appropriation. An appropriation for capital or additions to the net asset base of an agency provides authority for contributions by government to strengthen the agencies financial position. This category of appropriation is generally provided for the construction or purchase of new physical assets for the department, but may also be provided to meet a range of business needs including expansion of the departments role in providing outputs, or major strategic refocus of the agency. Many organisations today, therefore, have automatic access to capital funding which would have required specific appropriation in the past.

In a reverse of the trend towards greater devolution of budgetary responsibility to line management, control of the capital/asset budget appears to be becoming more centralised. It is interesting to speculate as to why this should be so. A possible explanation may be that the freer access to capital funding has necessitated a tighter control of this key resource. In any case, responsibility for the capital/asset investment budget has become more concentrated, with 29% of organisations assigning responsibility to the CEO (up from 17% in 1997) and a further 29% assigning responsibility to the CFO (up from 21% in 1997). The various means by which capital/asset funding is accessed shows a mix of capital injection and depreciation funding being the most common.

Finance skills within the organisation

The need for improved financial management skills in the public sector is highlighted by the latest survey. Of the organisations surveyed, many have been recruiting professionally qualified accounting and finance staff since 1997, with 82% now having a professionally qualified accountant in the role of senior finance manager (up from 70% in 1997).

As well as strengthening the professional skills of the senior finance position, organisations have also continued to upskill the rest of the finance staff, with 91% of respondents stating that the number of professionally qualified staff had increased over the past two years (up from 63% in 1997).

An interesting finding in the survey of CFOs was that the financial management skills of the line managers were rated lower than in 1997, a perception also held by the CEOs. When CFOs were asked how financially astute their line managers/budget holders were in the 2000 survey, only 28% rated them as very good or excellent compared to 59% in 1997.

The increasing complexity of the financial management task in most government organisations is probably testing the abilities of many staff, both from the line management and finance areas, as they tackle the process of adjustment from the previous cash-based management framework. It is therefore not surprising that the financial management competency may be deemed to be lower today than in 1997, as many staff will still be unfamiliar with the new environment.
This pattern is reflected across virtually every area of financial management. When CFOs were questioned about how they rated the finance skills of their finance staff, there was a downgrading in every key area compared with the 1997 result. Perhaps the introduction of new finance systems has been one of the most difficult areas for staff to become familiar with. Certainly, this is the area that has shown the strongest downgrading in competency. In the 1997 survey, CFOs of only 22% of organisations rated the accounting systems skills of their finance staff as ‘poor’ or ‘adequate’ whereas the number in these categories had risen to 45% by 2000.

**Balance sheet management issues**

Balance sheet management is a relatively new phenomenon in many jurisdictions. In fact, as recently as 1997 at least 10% of organisations surveyed had no-one responsible for the management of the overall balance sheet or for many of its sub-components.

In the 2000 survey, there are some significant trends emerging. The CEO is increasingly regarded as the person responsible for the overall management of the balance sheet (44% said the CEO was responsible for the balance sheet in 2000, up from 20% in 1997). The CFO is the other figure entrusted with responsibility for the balance sheet (48% in 2000, up slightly from 46% in 1997).

At the balance sheet component level (i.e. assets, liabilities, etc), management responsibility is considerably more devolved, with far fewer organisations citing the CEO as the responsible manager. This trend is consistent with good practice in making the manager who is ‘closest to the action’ the one responsible for the item. Two of the more notable areas of devolution are in relation to stock/inventory control and fixed asset management, where line managers have responsibility for these items in 70% and 41% respectively of the organisations surveyed. The CFO, however, retained responsibility in most organisations for balance sheet items of a monetary nature, including working capital management, banking and cash management and liability management.

3. Conclusion — Messages for the APS

**Lessons for the APS**

The survey results show that considerable progress has been made across the public sector in implementing a robust financial management framework that contains many elements of commercial accounting, budgeting and costing practice.

In most of the categories surveyed, there has been a marked change in the responses since the 1997 survey. In 1997, only a handful of jurisdictions across Australia had implemented financial management reform. By 2000, the majority had done so.

Wherever external factors have forced change on agencies, this is reflected in their responses, suggesting a high level of compliance, at least at the ‘mechanical’ level, with the reform process.

In some areas the take up rate by agencies has been very high. These include:

- Implementation of accrual-capable integrated financial management information systems
- Production of accrual-based external and internal reports; the preparation of budgets on an output basis
- Funding of depreciation through the appropriation process
• Use of incentive mechanisms such as the retention of asset sale proceeds.

It is in the less mandatory, more ‘people-oriented’ areas of reform that the results look less dramatic. The survey suggests that many organisations are still reluctant to move away from managing their budgets (at least internally) on a cash basis, and are using their systems to report information on both cash and an accrual basis. The preparation of dual information will add an overhead burden to departments and will send mixed messages to managers as to relevance of an accrual framework.

The survey also highlights that despite considerable recruiting and training of staff, perceptions of the financial management competencies of both finance staff and line managers have fallen since 1997. This suggests that (not unsurprisingly) staffs are still struggling to adapt to the new rules and the high levels of competency achieved under the old frameworks have temporarily been diminished. It will be interesting to study the answers to these questions in future surveys to see whether perceptions of staff financial management competency has risen.

The key findings highlighted above indicate a process of reform that has passed the implementation phase, but which still has some way to go to reach maturity. The widespread implementation of the reforms suggests that the process is now irreversible, but much effort will be needed to extract the benefits of the reforms at agency level.

Lessons for CEOs

The importance of the role of financial management in the public sector has become more widely recognised since the 1997 survey was conducted. At the CEO level specifically:

• More organisations are now reporting that achieving budgeted financial results is one of the CEOs major personal success factors
• CEOs are spending significantly more time on financial management matters, again indicating the higher priority that such matters now assume in the task list
• The CEO has taken increased responsibility for the financial performance in three key strategic areas: overall financial results, the capital investment budget and overall management of the balance sheet.

Lessons for CFOs

The role of the CFO in public sector organisations has continued to grow in importance since the previous survey, specifically:

• Almost half of the organisations surveyed reported that the CFO was now at a higher level in the organisation than in 1997— this is not unexpected, given the significant changes in the budgetary framework in many jurisdictions, which has placed a strong emphasis on financial management skill
• However, the combination of a more senior CFO role, together with the CEO’s increased accountability for financial performance, suggests that agencies will continue to pay increasing attention to financial management issues.

One of the weaker links in sustaining the financial management reform momentum and realising the potential gains of the reform is the lack of appropriately skilled line managers operating within the new financial management framework. While greater responsibility for resource management has been devolved, the development of the requisite skills to undertake these tasks does not appear to be occurring in line with the level of change.
The ultimate success or failure of financial management reform will largely be dependent on the extent to which sound financial management practice is embedded at the line management level. Managers must be able to understand what is expected of them before they can realistically be expected to perform successfully.

The way ahead

A number of lessons have emerged from this study which may help agencies to access the potential benefits which the implementation of the reform framework has to offer.

Strong endorsement of financial management reform is required at all of the important thought leadership levels—by Cabinet and responsible Ministers, by the central agencies and by line agency CEOs. Unless there is seen to be support at the highest levels for real reform, it will be very difficult to effect change at grass-roots level.

CEOs have a particular responsibility to provide leadership within their own agencies and to endorse the work of the CFO. This should involve providing clear guidance as to the expected performance requirements at the line management level. For example, achievement of performance targets at below budgeted cost should be acknowledged.

Overspending should not be rewarded with an increased budget allocation in subsequent budget rounds.

CFOs need to work hard to make their contribution add value to the organisation. Of course, the basic housekeeping tasks such as recording transactions, paying suppliers, preparing financial statements, internal reports and annual budgets must continue to be performed efficiently and effectively. It is, however, the advisory role—going ‘beyond mere bean counting’—where the CEO can make a strategic contribution to the organisation.

The CFO and their staff must be able to support decision making within the organisation. This may include such services as tailoring internal reports to the needs of line managers, providing guidance on costing issues, working with line managers to set output prices, assisting with fee-setting for cost recovery purposes, interpretation of variances, provision of financial management training and preparation of guidance material.

It is at the coal face—in the service delivery agencies that make the resourcing decisions—where the potential benefits of financial management reform are capable of being realised. CEOs, CFOs and line managers must take responsibility for training and developing their staff to develop their accrual management skills. Finance staff should be expected to have skills in the use of variance analysis, interpretation of accrual information, preparation of budget proposals, response to external events (such as cost reduction initiatives), use of performance indicators and management of balance sheet items.

Training will help to equip managers with the skills required to exercise sound financial management judgement. Of equal importance is the need for financial management to be recognised as part of the line manager’s job responsibility. Meeting financial targets should be built into the manager’s job description, performance pay (where appropriate) should be linked to financial management performance and the budget allocation process should reward rather than penalise the manager who out performs the budget. Furthermore the continued recruitment of professionally qualified business managers to CFO roles will be imperative for the sustainability of the financial management reforms.
In conclusion, the 1997 and 2000 surveys have focused closely on the implementation of financial management reform throughout the public sector. Future surveys should concentrate more on the impact the reforms are having on the performance of public sector agencies. This will provide the acid test as to whether all the effort to date spent on implementing reform has been worthwhile.
Some Better Practice Principles for Developing Policy Advice

Australian Auditor—General's Foreword

This booklet aims to enhance management and quality assurance of the policy advising function across the Australian Public Service (APS). It contains the better practice principles and a policy development checklist drawn from Audit Report No. 21 2001-02 entitled Developing Policy Advice. The objective of this audit was to determine whether departmental quality management systems for policy advising were appropriate and the advice provided met expected standards for policy.

The distinguishing feature and unique value of the public service is its role in providing policy advice based on promoting the public interest. In the June 2001 Centenary of the APS Oration, the Prime Minister stated:

The quality of any government is dependent, in large part, upon the quality of the advice it receives… Australia must be assured that its government…will be guided by considered, honest advice based on proper analysis, sound knowledge of administrative practice and sensible precedent.

The process of developing policy advice needs to be robust. While a good process does not necessarily guarantee a good policy outcome, the risks of poor process leading to an unsatisfactory outcome are very much higher. Policy advising is not an exact science. Consequently, any proposals and advice need to recognize the sensitivity of both being responsive to government objectives and fully informing the minister(s) concerned in a professional manner.

The Australian National Audit Office (ANAO) has provided this as guidance to all agencies from observations of better practice principles. However, the ANAO does not expect, nor suggest, that all the better practice principles and all components of the checklist be adopted or embraced in every circumstance. The principles and checklist should be assessed for relevance by all agencies for each policy development project. Hopefully, this should result in better policy advice that is both credible and reliable.

P. J. Barrett
Auditor-General
November 2001

Developing Policy Advice Better Practice Principles

The following better practice principles have been developed from issues raised during the course of the Developing Policy Advice audit, a review of policy advising literature and discussions with officials and other relevant experts.

Agency management of the policy advising function

- Develop a strategic perspective on policy advising requirements in corporate and business plans by identifying where policy development may be required to meet future needs or to respond to current problems.
- Ensure that business plans and performance information at all levels address the objectives and risks identified in higher level plans and risk assessments.
- Establish a system for obtaining ministerial feedback on performance measures for policy advice that:
is designed in consultation with the minister(s);
• has explicit and defined criteria for the quality of policy advice;
• captures feedback across the range of policy advice provided; and
• disseminates feedback to policy staff.

• Ensure that the departmental Annual Report provides a comprehensive and transparent assessment of performance against the indicators listed in the Portfolio Budget Statement.

Managing policy projects

• Manage risk as an integral part of management and quality assurance for policy projects, including conducting and documenting initial risk assessments.

• Make deliberate decisions about the level and quality of official documentation to meet obligations, capture precedents, and to manage risk and decision-making, including the need to preserve handwritten and electronic records of key discussions and of decisions.

• Provide documented guidance to relevant staff on the policy process that:
  • links policy processes to other corporate expectations and procedures; and
  • provides guidance on better practice tools, techniques and management processes.

• Determine, when preparing initial plans for large policy projects, the priorities for additional information gathering, analysis or consultation where more time for policy development becomes available, since decisions on such projects have a tendency to take longer than originally expected.

• Establish key controls for managing policy projects including:
  • a documented statement of the task;
  • mechanisms to monitor against timetables and quality standards;
  • defined and documented responsibility for reviewing and approving policy advice; and
  • a relevant interdepartmental advisory group where significant whole-of-government issues are involved.

• Determine whether the minister prefers to receive the majority of information in writing or orally, and ensure that a knowledgeable contact person is identified on written material and that the outcomes of key oral briefings are recorded.

Information gathering

• Conduct an initial assessment of information needs to set priorities and develop a strategy for acquiring it, but retain sufficient flexibility to respond to new information requirements that may be generated during the policy process.

• Where consultants are engaged, determine the selection criteria and document the evaluation to ensure that the chosen consultants are of appropriate quality and that the process is transparent.

• Report the impact of limitations on information to ensure that decision-makers can accurately assess the risks associated with making a decision on the level of information provided.
• Where it is material to the advice, identify the source of information in briefs and cabinet submissions to:
  • allow ministers to take into account the sources of information;
  • enable others to contest information and its use; and
  • establish a basis for future policy development.

• Conduct research on longer-term trends and coordinate it across agencies, to identify areas for possible future policy work and to provide a knowledge base to respond to emerging issues.

• Strengthen knowledge management and corporate memory by creating ‘knowledge pools’ within or across agencies in policy areas. These pools could include:
  • a directory of subject expertise across agencies;
  • a description of the current policy agenda and/or new policy projects; and
  • information on consultation documents, processes and responses, evidence used, impact assessments, policy evaluations and resources.

• Consider keeping core information and research expertise within the agency to benefit from accessibility, responsiveness and continuity, while using consultants for specialised services, advice and testing of information and policy approaches.

Consultation and coordination

• Identify issues where consultation is required and the risks associated with different consultative mechanisms.

• Ensure that consultation is undertaken with appropriate stakeholders by updating and reviewing existing lists of stakeholders and considering an active direct public consultation mechanism.

• Agree consultation plans and strategies with the minister.

• Provide individuals or organisations consulted with a statement of purpose that includes (where known) a brief and simple statement of purpose, a summary of policy proposals, a proposed implementation date where known, contact details for input, a point of contact for questions, and information on the timeframe for the consultation process and the policy decision process.

• Consider making pre-publication copies of research information available to ensure that individuals or organisations consulted have access to full information.

• Where some individuals or organisations have privileged access to the consultation process:
  • identify who has a need to know, what information is sensitive and actions required to meet Commonwealth information security policy and principles;
  • identify the risks of providing privileged access;
  • identify and implement treatment strategies, including documenting obligations, responsibilities, accountabilities and procedures to, for example, manage access to confidential information or potential conflicts of interest; and
  • ensure that legal obligations are identified and actions taken to ensure that they are respected.
• Establish knowledge networks of policy advisers across agencies to identify, research and coordinate policy based on themes. The networks could be guided by committees of officials that mirror the committees of cabinet.

Professional development
• Include human resources issues in risk assessments and business planning for policy advising and provide appropriate treatments for identified risks.
• Conduct regular skill assessments of policy staff to identify appropriate individual and agency-wide developmental needs.
• Include formal policy training as a component of policy staff development.
• Ensure that performance agreements for policy staff include:
  • a description of the policy work required that is consistent with other business planning documents;
  • criteria for assessing the policy work that are consistent with the criteria used by stakeholders to assess policy advice; and
  • links between work expectations, formal training and on-the-job training.
• Establish a senior government network in which ministers, senior government officials and other senior policy makers can meet from time to time for focused seminars on top-level management issues.

Review of the policy process
• Conduct a review at the end of at least significant policy advising projects, to identify strengths, lessons learned and opportunities for improvement in the policy process. The extent of review should be tailored to the particular circumstances, recognising that there is a range of possible approaches to achieve required effectiveness.
• Document the results of the review; feed them back into the policy advising process; and look for opportunities to share the results more widely.
• Commission periodic external reviews of the policy advising function, which examine the quality of the policy advising processes as well as of the policy advice output documents.
• Collect, assess and record the views of a range of stakeholders on the policy advising process and function as a basis for continuous improvement.

Developing Policy Advice Check List
The following checklist has been developed from criteria used during the course of the Developing Policy Advice audit and checklists supplied in The Australian Policy Handbook by Peter Bridgman and Glyn Davis, ‘Public Policy Advice’ in Public Sector Vol.14 No.3 by Dave Dickens and the Public Service Merit and Protection Commission Introductory Policy Formulation and Advice course notes.

Policy advice objectives
Has the objective been considered?
Have the problems with the status quo been identified?
Does the minister agree that a policy problem exists?
Have impediments to achieving the objective been acknowledged?
Are there in existence any related policies that need to be taken into consideration?
Are objectives and goals explicit and clear?
Should this matter go to cabinet?

Managing the policy cycle
Are staff allocated responsibility for coordinating policy responses within the agency?
Is there appropriate project planning and does it include a risk assessment?
Does the risk assessment address:
  • risks relating to coordinating within the agency?
  • risks relating to coordinating with other agencies?
  • risks relating to a whole-of-government approach?
Is the need for procedural integrity, and the separation of political and policy roles, understood and built into the policy development process?
Is the project timetable realistic?
Is the required funding properly targeted and fully budgeted?
Have information needs been determined?
Have cost effective strategies been established to fulfill information needs?
Are policy processes adequately documented? (including electronic documents).

Policy analysis
Has the issue been accurately formulated?
Are adequate skills available for well-rounded analysis?
Has the search for alternatives been thorough?
Have the appropriate analytical tools been used for the issue?
Have resource constraints, legal requirements and external accountability been taken into account in the policy advice?
Is there a superior alternative?
Has implementation been considered in policy design?
Have the limitations in the information been acknowledged?
Have relevant guidelines and procedures been identified and followed?

Consultation
Are the objectives of the consultation process clear?
Is the consultation process clearly linked to when and how a decision will be made?
Has an appropriate information, consultation, partnership, delegation or control strategy been developed?
Does the consultation timetable allow sufficient scope for meaningful input and consideration?
Are the resources to be committed to consultation commensurate with the importance of the problem?
Have all relevant stakeholders been identified and included?
Is appropriate access provided to the consultation process?
Has feedback from consultation been incorporated into policy advice?
Is the advice consistent with the public interest?
Coordination
Are proposals logical, well considered and consistent with other government initiatives?
Have all government agencies with an interest been identified?
Have appropriate mechanisms been created to test their thinking and gain support?
Have the regional, employment, industrial, equity and fairness consequences of the proposal been worked through?

Advice
Is the submission in the appropriate format?
Will the minister hear about relevant issues in a timely manner?
Is the aim of the advice clearly set?
Is the minister informed about contending opinion on the matter?
Are clear, different options available and presented honestly to the minister?
Are the consequences of each option provided to the minister?
Are features of the possible solution unethical, inequitable, inefficient, inappropriate or inexpedient?
Does the minister have sufficient information to make a decision?
  • budget information.
  • staff and other resource requirements.
  • legal implications.
  • social, environmental and other impacts.
  • technical data.
  • consultation and its results.
Is the information provided to the minister balanced and accurate?
Have the client’s views and priorities been taken into account?
Is the proposal cost effective?
Have policy alternatives been considered?

Review
Has feedback from the minister been received?
Has the policy process been reviewed internally?
Has an external party reviewed the policy process?
Have the results of the review been captured and disseminated?

The Australian National Audit Office welcomes any comments or suggestions on this booklet as part of the ongoing identification of good practice. For more information on this product or other Australian National Audit Office products please contact the Australian National Audit Office on 6203 7300 or visit our website at www.anao.gov.au.

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Australian National Audit Office Better Practice Guide on Contract Management

This Guide relates to contract management within a risk framework, specifically dealing with day-to-day contract management matters. The primary focus is on achieving required results, including value for money. The Guide is extensive in its coverage running to some 86 pages and is not reproduced here. Nevertheless, in view of the widespread interest in the application of risk management in the public sector, a substantial element of Part 1 of the Guide dealing with risk management and contracts is included here following the Auditor-General’s foreword which outlines some of the important issues in contract management. Some extracts from Part 2 of the Guide are also included to provide some indication of the better practice issues relating to the major processes of contract management.

Auditor-General’s Foreword

A large amount of information and better practice guidance has been issued on the topic of contracting, predominantly focused on the front-end of the contract process, that is, those stages leading to signing the contract. Audits undertaken in recent years generally indicate these stages are carried out quite well.

Our audits have also suggested that public sector managers are proficient at specifying their needs in tender documents and undertaking a tender evaluation process. However, organisations are less successful in seeking innovative solutions to the achievement of business outcomes from tenderers through the tender process for the achievement of required results. There also exists considerable room for improvement in the management of contracts. One of the most frequently asked questions during audits on contract management is where information and guidance can be found on better practice once the contract is signed.

The real work associated with contracts, particularly those close to an organisation’s core business and critical to its desired outcome(s), starts after the successful tenderer is identified and the contract is signed. However, as is being constantly reinforced, clear identification and articulation of contract requirements at the outset can save considerable time, cost and effort later in contract management. While this Guide is concerned with contracts rather than agreements or memorandum of understanding, such as those between public sector departments and agencies, there are many elements that are similar. One factor which experience shows can benefit all parties is to ensure at least some continuity between those involved in the tender stage and the contract negotiation stage and the actual contract management.

Private sector service providers are in business to primarily make a profit and to increase shareholder value. Commonwealth organisations, the recipients of these services, enter into the contracts primarily seeking the best value for money. These views are not mutually exclusive. Both can create significant risks and opportunities. Some of these risks can be managed through establishment of an effective operational framework during the contract negotiations, which goes a long way to enabling effective management of the contract over its life.
If parties enter into a contract with a good understanding of the other’s objectives, needs, goals and risks, it is possible that a best-fit solution will be found for the service delivery and opportunities for improved outcomes can be maximised for all concerned. This is what contract management should be about.

This Better Practice Guide contains research and experiences of better practices in contract management in Australia and internationally. It places considerable emphasis on achieving an appropriate contract relationship to best manage risk in each situation. While we expect contract managers to deal with these issues, it is the responsibility of chief executives and senior management to ensure their people are adequately skilled, empowered and resourced to enable them to do their job efficiently and effectively.

It is important that users take the ideas in this Better Practice Guide and adapt them appropriately to suit the needs of their particular organisation and the risks, nature and complexity of individual contracts. One size does not fit all circumstances. This Guide does not promote change for the sake of change. Rather, it provides a basis on which administrative processes may be considered against a well-designed risk management framework that encourages a focus on outcomes and results.

P.J. Barrett
Auditor-General
February 2001

Part 1—Risk management and contracts

Well-managed contracts can deliver significant benefits to an organisation. The difference between a contract delivering benefits and one that does not can be often attributed to the way that the risks associated with the delivery of those services are managed. Organisations may apply the principles of risk management to core business processes, but often do not effectively apply those same principles to contract management. While the provider may have more control over the risks associated with contract delivery, there is much the contract manager can do to plan for and contend with the impact of those risks.

The risk management process generally used in Australia and the Commonwealth today (and adopted in this Guide) is modelled on the Australian/New Zealand Standard AS/NZS 4360:1999 Risk Management. The Standard promotes a systematic methodology for identifying, assessing, treating and monitoring risks. In this context risks are defined as events that will impact on the ability of an organisation to achieve its objectives. Ideally, the risk management process should be applied to each step of the contract management lifecycle. For further information on managing risks, refer to the ANAO’s Better Practice Guide publication, “Business Continuity Management”.

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The figure to the left provides an overview of the risk management process.

A comprehensive approach to risk management considers risk treatments both actively (designing and implementing controls to prevent the risk events occurring) and re-actively (to mitigate the consequences should the risk events actually occur). Risk management, through structured decision making and a comprehensive analysis of business processes, provides opportunities for innovation and enhanced outcomes. Importantly, it is an on-going process.

Each of these steps is discussed below.

**Step One: Establish Context**

The first stage in the risk management process, with regard to contract management, is ensuring the contract is understood, by all parties, in the overall context of the organisation, that is:

- the outputs that the contracted services support;
- the critical success factors to the delivery of the outputs; and
- the internal input necessary for the delivery of the outputs.

When developing a strategy for managing the risks associated with contract management, it is important to have a thorough understanding of the services being delivered under the contract, the business outcomes and outputs those services support, the management environment and the business risks associated with that environment.

This information establishes the context that defines the overall priority of the contract to the organisation’s business. In turn, this priority determines the

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**Establishing the organisational context**

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Organisations should identify their key business processes and business support processes and relate them to their overall outcomes and outputs. Those activities, including the use of outsourced arrangements and contracts, and resources attributable to those critical processes, should be afforded the highest priority in undertaking risk assessments.
level of resources that should be allocated to the risk management and contract management processes.

By identifying the key business outcomes that are dependent upon contract-ed arrangements, this first step in overall risk management provides essential input to the risk identification and assessment process (Step 2).

**Step Two: Assess Risks**

In this step the organisation needs to:

- identify all non-trivial business risks (risk identification);
- analyse those risks (risk analysis); and
- design treatments that reduce the risks to an acceptable level (risk treatment design).

The following figure outlines the risk assessment phase of the risk management process and illustrates an approach that analyses risks before and after consideration of controls.
Risk Identification

There are at least two levels of risk associated with contracted service delivery:

- contract risk—the risk associated with the delivery of the service; and
- contract management risk—the risk associated with the management of the contract.

The principal contract risk to be managed is that the services will not be delivered in accordance with the requirements of the contract in terms of time, cost, quality and quantity. Many contract risks may arise externally and generally may be considered ‘beyond our control’. However, contract managers can establish an appropriate management framework that contributes to delivery standards being maintained and contingency arrangements to deal with unexpected problems as they arise.

The contract management risks are generally lower and arise from within the organisation (that is they are less likely to threaten delivery of service on which a key business process relies). Nevertheless, if the contract management is substandard, it may lead to erosion of the contract relationship and ultimately adversely affect service delivery. The following figure provides some examples of the more common internal and external risks found in contract management.

Risk analysis

Once the organisation has identified the contract risks, they need to be analysed. The exposures associated with contracted service delivery will most likely have a detrimental impact on the organisation’s outputs, but that will not always be the sole impact. Analysis of current business processes in assessing
contract risks can also provide opportunities to identify better ways of doing things and thereby enhance the operations of the organisation. Alternatively, inadequate delivery through either a failure of the service provider or poor contract management may also impact the organisation’s resources, reputation, compliance and may even cause business interruption. Invariably, there will always be an impact on clients where failure is associated with a key business process.

The business impacts (risk consequences) of contracted service delivery and contract management can arise from a range of risk events. Management should assess each event to determine if its occurrence could adversely affect the business objectives underpinned by the contracted service delivery.

Events with a direct, detrimental effect on the ability of the organisation to manage its contracts (or on the supplier achieving the specified delivery standards in terms of time, cost, quality and quantity) are likely to have some business impacts. These impact areas may be categorised by outputs, resources, reputation, business interruption, compliance and clients/stakeholders.

The analysis of business impact relies on establishing relevant evaluation criteria to assist in determining how significant a risk event will be. The criteria should be established on an escalating scale (low to high risk) against which the impact can be assessed.

Risk treatment design

The final step in risk assessment is to design appropriate risk treatments for the identified risks. The treatment options available to an organisation range from accepting the risk (where it cannot otherwise be cost-effectively managed), controlling the risk, through to transferring at least some of the risk.

It is not unusual for an organisation to enter into contractual arrangements in order to transfer risks, but not accountability. In a small organisation this may be in recognition of insufficient resources or expertise to deal with anticipated workloads, or simply to outsource delivery of a process not considered to be part of the organisation’s ‘core business’. Whatever the reason, contracts may transfer and mitigate one risk factor, but will create another risk factor in contract management.

In the context of contract management, the contract manager should consider a combination of preventative and detective controls to minimise the risk of failures in contract service delivery. The level and complexity of these controls will be directly proportional to the assessment of the importance of the contracted services (and the risk assessment undertaken) in achieving the business objectives and outputs of the organisation.

Contract managers should consider controls that will minimise the risks associated with:

- business outputs, eg. specified or planned levels of output activity cannot be achieved;
- resources, eg. the organisation suffers financial hardship as a consequence of the contract, substandard delivery or poor contract management;
- government accountability requirements and organisational reputation, eg. the contract itself, contract delivery or management of the contract leads to public embarrassment;
- business interruption, eg. failure in contract delivery causes an interruption to one or several key business processes;
- client and stakeholder interests, eg. clients and stakeholders suffer due to
substandard contract performance or poor contract management (this may include the service provider itself); and

- business exposure, eg. the contract, contract delivery, or contract management process lead to a legal or administrative exposure (which may, in turn, lead to a financial exposure to the organisation).

**Step Three: Implement Treatments**

This step in the risk management process requires organisations to establish a plan for implementing any new treatments, additional controls, or modifications to existing controls arising from the risk assessment phase.

The implementation plan should address contract risk management policies and procedures if they do not already exist. The strategies, plans and performance measures used in contract management are those treatments chosen to address or control the contract risks.

If the risk assessment process has functioned effectively it will have identified controls and treatments that reduce the overall likelihood and consequences of all risk events to an acceptable level.

Contract management policies and procedures will rely on a combination of preventative and corrective controls to be truly effective.

The Australian/New Zealand Standard AS/NZS 4360:1999 Risk Management recommends, as a minimum, documenting:

- who has overall responsibility for the implementation of the plan;
- what resources are to be utilised;
- the budget allocation;
- a timetable for implementation; and
- details of the mechanisms and frequency of reviews of organisational compliance with the treatment plan.

The design of treatments needs to consider what should be done in advance to minimise the consequences of a risk event and what should be done if, despite the organisation’s best efforts in managing the risk, the event still occurs and has a detrimental impact. For example, some organisations establish contracts for the supply of essential goods and services with a panel of suppliers. In the event that one supplier fails to deliver in line with agreed standards, orders can be placed at short notice with other suppliers on the panel.

**Step Four: Monitor and Review**

The objective of the final step in the risk management process is to monitor the risks and the effectiveness of the controls over time to ensure changing circumstances do not alter risk priorities or weaken the operation of controls.

Like any other controls, those used in contract management need to be reviewed regularly for effectiveness. Changes to the organisation’s objectives, structure or any other circumstances should be examined to ensure the controls in place for contract management remain valid and are the most appropriate to support the outcomes and outputs of the organisation. This, in turn, suggests controls should be flexible and adapt to the changing needs of the organisation.

**The impact of risk on relationships**

As the four relationship types exist along the continuum of relationship styles (Figure 1), different features may be ‘mixed and matched’ to develop the
most appropriate relationship style for the organisation and the particular contract.

In designing the most appropriate relationship, the risks of providing the service are critical to the decision process. The likelihood and consequence of failure affect risk. The relationship chosen is part of the treatment of the identified risk, that is, a means by which the risk will be controlled. The following figure demonstrates the link between risk and the relationship type. While the figure provides some examples of the type of goods or services that may be provided under the various relationship types, the choice depends on the organisation’s specific needs.

Whatever the choice, the relationship must fit the objectives of the service and the values and experience of both provider and purchaser.

The application of risk to contract management

Desirably, the provider would seek to address many of the risks included in Table 3, prior to implementation of the contract, for example ensuring a common understanding of the contract and its requirements before signing. Risks associated with the transition phase, ongoing management, and succession phases of the contract management lifecycle should be considered against the various steps in the framework for risk management. These considerations form the basis of the remainder of this Guide.
Part 2—Major processes of contract management

Beyond the terms and conditions of the contract, contract management has three key stages:

- transition phase (or implementation);
- ongoing day-to-day management; and
- evaluation and succession planning.

This Part of the Guide discusses the steps to be carried out by contract managers in undertaking the transition phase; facilitating effective ongoing management; and developing a well thought out succession plan. The extent to which these stages require individual strategies will depend upon both the risk assessment and the nature and complexity of the contracts.

The Guide addresses each of these stages on the understanding that much of what dictates the behaviour and expectations of each party are the terms and conditions of the contract and the risks to be managed. Once the contract is agreed to, the terms and conditions form the basis of all activity relating to the provision of the goods or services and are therefore taken as a given in this Guide.

Important elements of the transition phase include establishing the contract relationship.
Establishing the contract relationship

Announcing the decision to the successful tenderer is the first step in establishing the working relationship that will underpin the service delivery. The future quality of the relationship will depend as much on the effort and commitment put in by the organisation up-front, as the on-going effort throughout the contract term.

A very important part of the relationship is the art or skill of negotiation. Negotiation is about open and frank discussion. Negotiation skills may be required to establish the expected requirements of operation or to get approval on a variation or to settle a claim.

The contract manager must ensure that the required delegated powers to negotiate have been given and are at the appropriate level. If a provider thinks that a contract manager can discuss and negotiate on a particular topic, but in fact cannot (or only a part of the whole topic), then the chances of agreement are slim. In such cases the view of the purchaser can be tainted for future meetings. Ensure at the start of the negotiation that the boundaries are very clearly spelt out.

The transition strategy needs to:
• keep the focus on the changes required;
• facilitate appropriate resource allocation;
• undertake contingency planning (ie running ‘what if’ scenarios);
• facilitate open discussion on the service requirements;
• ensure full understanding of the needs and expectations of each party;
• set the rules for the rest of the contract; and
• outline all tasks to be completed with clear responsibilities for completing them.

Preparing the resource plan

In order to facilitate an effective transition, both the purchaser and provider need to develop and agree on a resource plan. The resource plan quantifies the number of resources required for each major task, the timing of each and any specialist skills required for each person concerned. Resource requirements for traditional and non-traditional contract types vary because of the nature of the goods or services likely to be provided and depend on what the purchaser wishes the provider to deliver. Commonly, contracts require resources and systems to be developed by the provider (including quality procedures, data collection devices, reporting processes, claims for payment formats and complaints handling processes).

The contract manager

One of the most important decisions will be the appointment of the contract manager. It is this person, in cooperation with the provider, who will have the opportunity to influence the success or failure of a contract. Depending on the risk assessment undertaken by the organisation, the time required to manage a contract may be full or part-time. In the purchaser/provider regime that is becoming more common-place in the public sector, it is likely that people who have never managed a contract are now required to do so in addition to their usual duties. It may also mean that the person managing a contract is not initially skilled to effectively undertake this new activity. Organisations need to provide managers with the opportunity to acquire the necessary skills and personal attributes to increase the likelihood of successful contract management.
Ongoing management of the contract

This phase covers the life of the contract from the commencement to termination dates. It is this phase that largely tests the success of the management of the contract, particularly management by the purchaser.

The contract manager’s responsibility, during the ongoing management of the contract, is to ensure risks from both external and internal sources that were clearly identified as part of the risk assessment process referred to earlier, are managed to ensure effective delivery of the contracted service. That is, the treatments for these risks continue to be appropriate and operating effectively. The Guide provides a framework for this ongoing management role. The extent to which any of the ideas discussed below are adopted depends upon the size and complexity of the contract, the assessment of the risks to organisational outcomes and the experience of the contract manager. One size does not fit all situations.

Developing service level agreements (SLA)

Better practice suggests that service levels should be included in the tender documentation or negotiated during the tender/contract negotiations and included in the contract. One of the first steps in the ongoing management of the contract (whether performance based or not) is the development and documentation of these contracted service delivery standards in conjunction with the provider. This documentation commonly takes the form of a SLA. Depending on the nature and complexity of the contract, a SLA can range from being a simple one page list of standards through to a comprehensive schedule encompassing a number of agreements negotiated in detail with key clients and stakeholders. Contracts for non-complex/non-core services may not require a SLA, provided that performance levels have been adequately addressed in the contract documentation. Where the contract for services is more complex, and a SLA is required, the standards for service delivery should reflect the survey of needs that were established at the time of the initial purchase decision.

Measurement and feedback on contract performance will be based on the SLA and span all areas of the delivery from the initial setting of the strategy to the final closeout and report on the actual delivery. The following figure shows the stages contained within the service delivery cycle.
Performance Measurement System (PMS)

The contract manager is responsible for ensuring measurement and monitoring of actual performance in relation to the planned or desired performance as outlined in the performance based contracts and SLAs. In order for the contract to be monitored, a performance management system (PMS) should be developed and applied to monitoring of service levels. The extent of the PMS and the effort required to establish it depends on the size and complexity of the contract and the number of contracts being managed by the contract manager. The PMS should recognise the dependencies between the performance of the provider and purchaser. Consideration should be given in the PMS to the impact of the performance of the purchaser on the providers. As with any relationship, success is a result of the efforts of both parties. The PMS seeks to provide a monitoring framework by which the contracted services will be measured and/or assessed.

Problem solving

Problem solving (also called root cause analysis) endeavours to establish the root cause or reason for failures or successes. Having identified (either by benchmarking or other such measurement) current performance levels, the organisation will need to establish the reason behind any failures in order to reach the agreed service levels. Problem solving is a process by which cause and effect activities and/or outputs are systematically analysed until a root or source has been identified. Corrective action can then be taken to remedy the exact cause or problem identified sooner rather than later.

Performance reporting

In order to effectively monitor progress of the contract, the contract manager needs to establish a reporting regime that matches the nature and complexity of the contract being managed, in order to monitor effectively the performance of the provider. The contract manager should acknowledge the impact that the performance of the purchaser has on the provider and adjust information presented in performance reports to reflect this dependency.

Documentation

The success of a contract may very well depend on the accuracy and credibility of the information recorded. Therefore, it is important to maintain and review the information gathered and keep it organised and user friendly for easy and reliable access.

For public sector purposes it is also important to keep appropriate records to demonstrate that ethical standards have been observed, that money has been well spent and that decisions can be sustained through any administrative or judicial review.

Managers need to ensure that the contract deliverables are actually being delivered. This can be difficult as a provider may be asked to submit a mass of information that detracts from the provision of those reports that are really useful. Most commonly this is due to the tender statement of requirements being a combination of all previously requested information plus new ideas.

Information systems

One issue that contract managers face is maintaining the information needed by the purchaser to carry out a number of functions such as benchmarking, measuring or assessing continuous improvement, quantifying failures and specifying achievement of objectives.
The use of a single information system allows the physical recording of the data to become the provider’s responsibility and frees contract managers to focus mainly on spot checking.

**Variations**

One of the roles of contract managers is the control and processing of variations to the contract. The contract manager will need the authority and a flexible approach from which change can be based. They may need to negotiate such matters as price, the standards to be delivered and a timeframe for actioning. The contract manager will need enough information to be able to negotiate a fair price, agree whether standards are realistic and reflect client expectations and set a realistic timeframe for application. Being prepared for negotiations can take considerable effort in, for example, clearly defining the change, establishing a market price using industry experience and confirming client/stakeholder expectation.

The approach taken for the variation(s) depends on the form of contract used for the service delivery and is summarised by relationship type. Under a traditional contract (that relies on control and compliance), variations will tend to be fully scoped with pricing established before the work is undertaken. In alliance and partnering relationships (based on a more flexible and cooperative working approach), variations may be less structured, for example with invoices provided after the work is done and based on an initial agreed cost structure. Renegotiating the initial contract to accommodate variations is likely only to be necessary for significant changes to the original scope.

**Payment processes**

Before payment to the provider can be approved, the contract manager needs to be satisfied the work has been completed in accordance with the contract and SLA. The PMS and reporting documentation, discussed earlier in this Guide, play an important part in providing that assurance to the contract manager.

**Contract succession**

This phase of the contract management lifecycle looks at ensuring a smooth succession phase at the end of the contract period to ensure minimal impact on the business of the organisation. The number of issues at this stage and the effort required to manage them, will depend on the nature and complexity of the contracted service.

The contract succession phase, which may commence before the contract is completed, also involves a review of the successes and failures that occurred over time in the contract arrangements. It is particularly beneficial to establish whether the issues that arose resulted from difficulties with the initial tender specifications or the signed contract itself (including the form of relationship that resulted from the contract and the pricing regime put in place).

This phase may involve undoing all the arrangements previously in place to allow for a completely new service provider to take over, or to bring the service delivery back in-house if that is feasible. Whatever the succession proposal, the resource commitment necessary will likely be similar to that involved in the initial transition phase.

Experience has shown that most problems with contracted service delivery occur because of an inadequate transition phase that lead to misunderstandings about the deliverables. This situation may then be exacerbated by the manner in which the contract relationship is managed.
The succession phase is therefore about learning lessons and establishing a clearer understanding of what makes contract management successful. These lessons will then form the basis of the planning, tender requirements and negotiations for the next contract. The remainder of this section of the Guide looks at options that address some of the issues that can arise in contract service delivery.

OECD Best Practices for Budget Transparency

Office for Economic Co-operation and Development
Public Management Service
Public Management Committee
PUMA/SBO(2000)6/REV1
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Background

1. Sound governance arrangements are essential for strengthening pluralistic democracy, promoting economic prosperity and social cohesion, and for maintaining confidence in public administration. Transparency—openness about policy intentions, formulation and implementation—is a key element of good governance. The budget is the single most important policy document of governments, where policy objectives are reconciled and implemented in concrete terms. Budget transparency is defined as the full disclosure of all relevant fiscal information in a timely and systematic manner.

2. OECD Member countries are at the forefront of budget transparency practices. At its 1999 annual meeting, the OECD Working Party of Senior Budget Officials asked the Secretariat to draw together a set of Best Practices in this area based on Member countries’ experiences.

3. The Best Practices are in three parts. Part I lists the principal budget reports that governments should produce and their general content. Part II describes specific disclosures to be contained in the reports. Part III highlights practices for ensuring the integrity of the reports.

4. The Best Practices are designed as a reference tool for Member and non-member countries to use in order to increase the degree of budget transparency in their respective countries.

   The Best Practices define “government” in line with the System of National Accounts (SNA). This definition encompasses the non-commercial activities of government. Specifically, the activities of state-owned enterprises are excluded from this definition. Although the SNA definition focuses on general government, i.e. consolidating all levels of government, these Best Practices should be seen to apply to the national government.

1. Budget Reports

1.1 The Budget

   • The budget is the government’s key policy document. It should be comprehensive, encompassing all government revenue and expenditure, so that the necessary trade-offs between different policy options can be assessed.
• The government’s draft budget should be submitted to parliament far enough in advance to allow parliament to review it properly. In no case should this be less than 3 months prior to the start of the fiscal year. The budget should be approved by parliament prior to the start of the fiscal year.

• The budget, or related documents, should include a detailed commentary on each revenue and expenditure programme. Non-financial performance data, including performance targets, should be presented for expenditure programmes where practicable.

• The budget should include a medium-term perspective illustrating how revenue and expenditure will develop during, at least, the two years beyond the next fiscal year. Similarly, the current budget proposal should be reconciled with forecasts contained in earlier fiscal reports for the same period; all significant deviations should be explained.

• Comparative information on actual revenue and expenditure during the past year and an updated forecast for the current year should be provided for each programme. Similar comparative information should be shown for any non-financial performance data.

• If revenue and expenditures are authorised in permanent legislation, the amounts of such revenue and expenditures should nonetheless be shown in the budget for information purposes along with other revenue and expenditure.

• Expenditures should be presented in gross terms. Ear-marked revenue and user charges should be clearly accounted for separately. This should be done regardless of whether particular incentive and control systems provide for the retention of some or all of the receipts by the collecting agency.

• Expenditures should be classified by administrative unit (e.g., ministry, agency). Supplementary information classifying expenditure by economic and functional categories should also be presented.

• The economic assumptions underlying the report should be made in accordance with Best Practice 2.1 (below).

• The budget should include a discussion of tax expenditures in accordance with Best Practice 2.2 (below).

• The budget should contain a comprehensive discussion of the government’s financial assets and liabilities, non-financial assets, employee pension obligations and contingent liabilities in accordance with Best Practice 2.3-2.6 (below).

1.2 Pre-Budget Report

• A pre-budget report serves to encourage debate on the budget aggregates and how they interact with the economy. As such, it also serves to create appropriate expectations for the budget itself. It should be released no later than 1 month prior to the introduction of the budget proposal.

• The report should state explicitly the government’s long-term economic and fiscal policy objectives and the government’s economic and fiscal policy intentions for the forthcoming budget and, at least, the following two fiscal years. It should highlight the total level of revenue, expenditure, deficit or surplus, and debt.

• The economic assumptions underlying the report should be made in accordance with Best Practice 2.1 (see below).
1.3 Monthly Reports

- Monthly reports show progress in implementing the budget. They should be released within 4 weeks of the end of each month.
- They should contain the amount of revenue and expenditure in each month and year-to-date. A comparison should be made with the forecast amounts of monthly revenue and expenditure for the same period. Any in-year adjustments to the original forecast should be shown separately.
- A brief commentary should accompany the numerical data. If a significant divergence between actual and forecast amounts occurs, an explanation should be made.
- Expenditures should be classified by major administrative units (e.g., ministry, agency). Supplementary information classifying expenditure by economic and functional categories should also be presented.
- The reports, or related documents, should also contain information on the government’s borrowing activity (see Best Practice 2.3 below).

1.4 Mid-Year Report

- The mid-year report provides a comprehensive update on the implementation of the budget, including an updated forecast of the budget outcome for the current fiscal year and, at least, the following two fiscal years. The report should be released within six weeks of the end of the mid-year period.
- The economic assumptions underlying the budget should be reviewed and the impact of any changes on the budget disclosed (see Best Practice 2.1).
- The mid-year should contain a comprehensive discussion of the government’s financial assets and liabilities, non-financial assets, employee pension obligations and contingent liabilities in accordance with Best Practices 2.3 - 2.6 (below).
- The impact of any other government decisions, or other circumstances, that may have a material effect on the budget should be disclosed.

1.5 Year-End Report

- The year-end report is the government’s key accountability document. It should be audited by the Supreme Audit Institution, in accordance with Best Practice 3.3 (below) and be released within six months of the end of the fiscal year.
- The year-end report shows compliance with the level of revenue and expenditures authorised by parliament in the budget. Any in-year adjustments to the original budget should be shown separately. The presentation format of the year-end report should mirror the presentation format of the budget.
- The year-end report, or related documents, should include non-financial performance information, including a comparison of performance targets and actual results achieved where practicable.
- Comparative information on the level of revenue and expenditure during the preceding year should also be provided. Similar comparative information should be shown for any non-financial performance data.
- Expenditure should be presented in gross terms. Ear-marked revenue and user charges should be clearly accounted for separately.
- Expenditure should be classified by administrative unit (e.g., ministry, agency). Supplementary information classifying expenditure by economic and functional categories should also be presented.
• The year-end report should contain a comprehensive discussion of the government’s financial assets and financial liabilities, non-financial assets, employee pension obligations and contingent liabilities in accordance with Best Practices 2.3 - 2.6 (below).

1.6 Pre-Election Report
• A pre-election report serves to illuminate the general state of government finances immediately before an election. This fosters a more informed electorate and serves to stimulate public debate. Optimally, this report should be released no later than 2 weeks prior to elections.
• The report should contain the same information as the mid-year report.
• Special care needs to be taken to assure the integrity of such reports, in accordance with Best Practice 3.2 (below).

1.7 Long-Term Report
• The long-term report assesses the long-term sustainability of current government policies. It should be released at least every 5 years, or when major changes are made in substantive revenue or expenditure programmes.
• The report should assess the budgetary implications of demographic change, such as population ageing and other potential developments over the long term (10-40 years).
• All key assumptions underlying the projections contained in the report should be made explicit and a range of plausible scenarios presented.

2. Specific Disclosures

2.1 Economic Assumptions
• Deviations from the forecast of the key economic assumptions underlying the budget are the government’s key fiscal risk.
• All key economic assumptions should be disclosed explicitly. This includes the forecast for GDP growth, the composition of GDP growth, the rate of employment and unemployment, the current account, inflation and interest rates (monetary policy).
• A sensitivity analysis should be made of what impact changes in the key economic assumptions would have on the budget.
• An assessment of alternative economic scenarios should be made and what impact they would have on the budget.

2.2 Tax Expenditures
• Tax expenditures are the estimated costs to the tax base of preferential treatment for specific activities.
• The estimated cost of key tax expenditures should be disclosed as supplementary information in the budget. To the extent practicable, a discussion of tax expenditures for specific functional areas should be incorporated into the discussion of general expenditures for those areas in order to inform budgetary choices.

2.3 Financial Liabilities and Financial Assets
• All financial liabilities and financial assets should be disclosed in the budget, the mid-year report, and the year-end report. Monthly borrowing activity should be disclosed in the monthly reports, or related documents.
• Borrowings should be classified by the currency denomination of the debt, the maturity profile of the debt, whether the debt carries a fixed or variable rate of interest, and whether it is callable.

• Financial assets should be classified by major type, including cash, marketable securities, investments in enterprises and loans advanced to other entities. Investments in enterprises should be listed individually. Loans advanced to other entities should be listed by major category reflecting their nature; historical information on defaults for each category should be disclosed where available. Financial assets should be valued at market value.

• Debt management instruments, such as forward contracts and swaps, should be disclosed.

• In the budget, a sensitivity analysis should be made showing what impact changes in interest rates and foreign exchange rates would have on financing costs.

2.4 Non-Financial Assets

• Non-financial assets, including real property and equipment, should be disclosed.

• Non-financial assets will be recognised under full accrual based accounting and budgeting. This will require the valuation of such assets and the selection of appropriate depreciation schedules. The valuation and depreciation methods should be fully disclosed.

• Where full accrual basis is not adopted, a register of assets should be maintained and summary information from this register provided in the budget, the mid-year report and the year-end report.

2.5 Employee Pension Obligations

• Employee pension obligations should be disclosed in the budget, the mid-year report and the year-end report. Employee pension obligations are the difference between accrued benefits arising from past service and the contributions that the government has made towards those benefits.

• Key actuarial assumptions underlying the calculation of employee pension obligations should be disclosed. Any assets belonging to employee pension plans should be valued at market value.

2.6 Contingent Liabilities

• Contingent liabilities are liabilities whose budgetary impact is dependent on future events which may or may not occur. Common examples include government loan guarantees, government insurance programmes, and legal claims against the government.

• All significant contingent liabilities should be disclosed in the budget, the mid-year report and the annual financial statements.

• Where feasible, the total amount of contingent liabilities should be disclosed and classified by major category reflecting their nature; historical information on defaults for each category should be disclosed where available. In cases where contingent liabilities cannot be quantified, they should be listed and described.
3. Integrity, Control and Accountability

3.1 Accounting Policies

- A summary of relevant accounting policies should accompany all reports. These should describe the basis of accounting applied (e.g., cash, accrual) in preparing the reports and disclose any deviations from generally accepted accounting practices.
- The same accounting policies should be used for all fiscal reports.
- If a change in accounting policies is required, then the nature of the change and the reasons for the change should be fully disclosed. Information for previous reporting periods should be adjusted, as practicable, to allow comparisons to be made between reporting periods.

3.2 Systems and Responsibility

- A dynamic system of internal financial controls, including internal audit, should be in place to assure the integrity of information provided in the reports.
- Each report should contain a statement of responsibility by the finance minister and the senior official responsible for producing the report. The minister certifies that all government decisions with a fiscal impact have been included in the report. The senior official certifies that the finance ministry has used its best professional judgement in producing the report.

3.3 Audit

- The year-end report should be audited by the Supreme Audit Institution in accordance with generally accepted auditing practices.
- Audit reports prepared by the Supreme Audit Institution should be scrutinised by parliament.

3.4 Public and Parliamentary Scrutiny

- Parliament should have the opportunity and the resources to effectively examine any fiscal report that it deems necessary.
- All fiscal reports referred to in these Best Practices should be made publicly available. This includes the availability of all reports free of charge on the Internet.
- A public commitment to the exact date on which each fiscal report will be released should be made at the beginning of the year (“advance release calendar”).
- The finance ministry should actively promote an understanding of the budget process by individual citizens and non-governmental organisations.
Mitigating the Risks Arising in Planning Estimates of Transfers from the European Union’s Structural and Cohesion Funds in Hungary

Peter Heil, Ph.D. (Office of the Prime Minister, Hungary) and Árpád Kovács, Ph.D. (State Audit Office, Hungary)

Introduction

Countries throughout Europe, and especially the European Union, are concerned about reducing the risk of public spending not being directed towards government priorities. Although all kinds of economic assistance and government expenditure involve the risk of mismanagement and influence the ability of governments to budget and strategize, this risk is particularly relevant when considering the extension of European taxpayers’ money to European Union countries through transfers. Complexities related to the use of resources granted from the different Structural and Cohesion Funds of the European Union have an influence on the national budgets of recipient nations and also create new control requirements in these countries. This paper describes some of these challenges and the new financial management mechanisms required of European Union countries, with a final section that gives specific attention to the role of the Audit Office.

The State Audit Office of Hungary is legally bound to audit the nation’s budget appropriations, and is obliged annually to submit an opinion on the budgetary bill, which relates details of how funds are used. Naturally, the State Audit Office is not the sole actor on this very important stage. Hungary faces a new challenge, the accession to the European Union. Our topic is among the most important financial issues to be solved in such an accession process, with the audit office now having the challenge of ensuring that Union funds are properly accounted for and that risks of mismanagement are mitigated. That is why this article focuses on this topic, which is common in many other Central and Eastern European Countries.

The main emphasis in the discussion on the role of the audit office is the attempt in Hungary to form an opinion on those important documents affecting the state budget that relate to accession. In its Strategy document, the State Audit Office relates to lessons learned and challenges associated with accession, stating that it “has gained and continues to gain considerable audit experience in respect with the assistance received from the EU. This experience offers adequate basis for preparing to perform audit tasks after accessing the EU. By the time of the accession, the State Audit Office must also have developed guidance documents that offer briefing in connection with audits on the contributions made to the EU budget and on the assistance received from the EU budget.” Another issue that the Audit Office must deal with, as it relates to accession, is the degree to which auditors should play a policy-making role. In general, the State Audit Office refrains from intervening in the decision-making processes. However, it is being required to do so in its duty to form an opinion on the
budgetary bill, to provide input into (and control over) the National Development Plan required for accessing European Union funds and in the advisory role it plays to the Parliament which is demanded in many ways by the MPs.

The pre-accession process

Accession to the European Union represents not only the achievement of a historic objective, but also a major challenge to Hungarian society in all sectors of social and economic life. In order to be prepared for that challenge, during the last decade, Hungary has undergone sweeping changes. The total restructuring of the economy was accompanied by a complete remodelling of the Hungarian state. Above all, economic policies had to be brought into line with free market principles. The state budget had to be consolidated—a long and difficult process that brought about a number of painful reforms in the social and health sectors.

In this process the state ceased to be the dominating player in the economy. Large scale privatisation helped not only to restructure industry and trade, it also provided important income to scale down national debt to a level that is no longer an insurmountable obstacle to sustainable growth. In parallel, national legislation has been adjusted to the European Union’s legal rules, the acquis communautaire. State institutions have been reshaped and strengthened in order to be able to ensure the full application of European Law in Hungary. As a result of the Association Agreement with the EU in 1991, Hungarian enterprises have gradually become integrated into the Single European Market. Trade in industrial goods is now free from any quantitative or qualitative restrictions. The free flow of capital and the right of establishment for enterprises is also mutually guaranteed. All of this means—as recognised by the European Commission’s recent report on Hungary’s preparations for EU membership—that Hungary is now ready for membership.

EU—support for economic development

One of the many consequences of the accession process is that Hungary’s economic development policies will have to adjust to a totally new environment. While European legislation on state aid will limit the government’s freedom to grant state aid to any economic operator, the budgets available for state-sponsored infrastructure development, enterprise promotion, regional economic programmes, job creation or environmental investments are expected to grow significantly after 2004. As one of the poorer member states of the European Union in the future, Hungary will become eligible for large-scale financial transfers from the Community Budget. These transfers, financed by the European Union’s Structural and Cohesion Funds are used to “promote economic and social cohesion,” in other words, to reduce economic and social disparities among the different countries and regions of the EU.

The Structural and Cohesion Funds are used to sponsor three major kinds of development goals: Objective 1: Promoting the development and structural adjustment of regions whose development is lagging behind; Objective 2: Supporting the economic and social conversion of areas facing structural difficulties; and Objective 3: Facilitating the adaptation and modernisation of policies and systems of education, training and employment—(applied outside Objective 1 areas). The financial instruments used to attain these objectives are: the Structural Funds and the Cohesion Fund. Included within the Structural
Funds are the European Regional Development Fund (ERDF), the European Social Fund (ESF), the European Agricultural Guidance and Guarantee Fund (EAGGF), Guidance Section, and the Financial Instrument for Fisheries Guidance (FIFG).

The average annual level of support attainable from these funds is currently around 250 euros per capita in the most underdeveloped Objective 1 regions, where GDP levels are less than 75% of EU average. The maximum level of support to any member state—from all EU funds combined—is 4% of the Gross Domestic Product. With the enlargement of the European Union the size and population of Objective 1 areas will grow significantly. Virtually the entire national territory of the new member states acceding from 2004 falls under Objective 1. This puts a considerable strain on the Community’s budget.

The introduction of the funds in these countries will be gradual. According to the current standing of the accession negotiations, between 2004 and 2006, the new member states will receive only around 40-50% of the structural support and only 10-20% of the direct agricultural subsidies to which they would normally be entitled. Another major difference is the expected higher share of the Cohesion Fund from the overall financial envelope (30% of EU support vs. 15% in the CF’s current beneficiary countries). Thereby the EU is seeking to do justice to the higher investment needs in major transport and environmental infrastructure in the countries of Central and Eastern Europe.

Negotiations are not yet over, and Central European countries are not satisfied with the financial offer of the Union. But even if the financial framework cannot be improved significantly, drawing down and efficiently using EU financial transfers will be a major challenge for all beneficiaries.

The procedural framework of EU development policy

In Objective 1 countries, like Hungary, the use of the Structural Funds is conditional on the preparation of a so-called National Development Plan, or NDP. This will serve as the basis for using EU funds, outlining the objectives and measures for which the financial transfers of the Community, alongside the compulsory national co-financing of at least 25% shall be used. The preparation of this plan is guided by four major principles:

- The principle of programming refers to the obligation of each beneficiary country to derive its development objectives from a comprehensive, scientific analysis of its economic and social situation, and select concrete targets in line with the Structural and Cohesion Fund’s mission, as well as the limitations and obligations imposed by the Community’s policies (e.g., as regards environmental protection, the freedom of economic competition, the transparency public procurement and financial processes, and equal opportunities).

- According to the principle of partnership the preparation and the implementation of the NDP has to be overseen jointly by the government, the regions, local governments, as well as economic players (employers federations, trade unions) and non-governmental organisations. Apart from the obligation to submit the draft NDP for wide-ranging public debate during the programming process, each country will establish, upon starting to implement the NDP, a number of Monitoring Committees. These Committees are made up by the representatives of the aforementioned stakeholders who will then collectively decide on the development programmes to be undertaken as well as any needs for adjusting these programmes, in case so warranted by practical results and experience of implementation. It is perhaps important to note, that the application of the partnership principle is compulsory, regardless of
the given country’s administrative system (subsidary vs. centralism) or the government’s approach to social dialogue in economic policy (corporative or free-market).

• In line with the principle of additionality, EU funding will always be used alongside national resources, as the EU does not seek to substitute, but to complement national efforts. This requirement is applied in two ways. On the one hand, the beneficiary state—more accurately, the state and private sectors together—have to provide at least 25% of the total cost of each measure. On the other, the levels of budgetary spending on development policy prior to the start of the NDP have to be maintained throughout the period covered by EU support.

• Last but not least, there has to be concentration. As there always will be more legitimate development needs than resources, the NDP has to focus on a limited number of objectives. As the intensity of aid in a certain area is increased, assistance becomes more effective and more measurable.

The NDP is broken down into Operational Programmes (Ops). In the case of Hungary, there will be five Ops—4 of them sector, and 1 targeting regional measures. The content of the Hungarian Operational Programmes is as follows:

<table>
<thead>
<tr>
<th>Economic Competitiveness</th>
<th>Investment promotion, SMEs, R+D, energy, information society</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure</td>
<td>Environmental, transport infrastructure</td>
</tr>
<tr>
<td>Human Resources</td>
<td>Employability, knowledge-based economy, social inclusion, equal opportunities education, social and health affairs</td>
</tr>
<tr>
<td>Rural Development</td>
<td>Increased growth of rural areas, healthy and balanced structure of the rural economy, competitive agriculture and food processing</td>
</tr>
<tr>
<td>Regional Development</td>
<td>Integrated local development actions for sustainable growth and employment</td>
</tr>
</tbody>
</table>

The NDP has to be submitted by the beneficiary state, then approved by the European Commission. The approval of the Commission is preceded by detailed negotiations, which result in the compilation of the so-called Community Support Framework, or CSF. The implementation of the NDP/CSF can start when it is approved by the EU Commission—but of course not earlier than accession. Within 3 months after that start, Monitoring Committees, based on the principle of partnership, must be set up. The planning period of the NDP/CSF is identical to that of the multi-annual budgetary framework of the Community. Accordingly, it will last from accession to the end of 2006. Halfway through the planning period a mid-term evaluation has to be organised. Funds allocated under the NDP must be spent within two years of the last programming year, i.e. before the end of 2008. In the case of Hungary, the NDP is due to be submitted by the end of this year, and it should be approved by the Commission in 2003. The start of implementation is scheduled for early 2004.

The Institutions responsible for EU assistance

The structure of the NDP then determines the institutional structure that the beneficiary state is required to set up. On the one hand, for each Operational Programme, there has to be a Managing Authority and a Monitoring Committee. On the other, there has to be a Paying Authority responsible for each of the Structural Funds and the Cohesion Fund. The tasks of all of these bodies are exactly prescribed by EU law. Accordingly, the Managing Authority
shall be responsible for the efficiency and correctness of management and implementation, and in particular for:

a. Setting up a system to gather reliable financial and statistical information on implementation, for the monitoring indicators and for evaluation, using where possible computer systems permitting the exchange of data with the Commission;

b. Adjustment of the programme (during implementation, if there is a need);

c. Drawing up and, after obtaining the approval of the Monitoring Committee, submitting to the Commission the annual implementation report;

d. Organising, in co-operation with the Commission, the mid-term evaluation;

e. Ensuring that those bodies taking part in the management and implementation of the assistance maintain either a separate accounting system or an adequate accounting code for all transactions relating to the assistance;

f. Ensuring the correctness of operations financed under the assistance, particularly by implementing internal controls in keeping with the principles of sound financial management and acting in response to any observations or requests for corrective measures adopted;

g. Ensuring compliance with Community policies in the context of the application of Community rules on the award of public contracts;

h. Compliance with the obligations concerning information and publicity.

Without prejudice to the provisions of this Regulation, the managing authority shall act in full compliance with the institutional, legal and financial systems of the Member State concerned in carrying out its tasks.

The Monitoring Committee shall satisfy itself as to the effectiveness and quality of the implementation of assistance, it shall confirm or adjust the programme complement, including the physical and financial indicators to be used to monitor the assistance. The Paying Authority means one or more national, regional or local authorities or bodies designated by the Member States for the purposes of drawing up and submitting payment applications and receiving payments from the Commission. The paying authority shall ensure that final beneficiaries receive payment of their contribution from the Funds as quickly as possible and in full. In Hungary, the National Treasury—under the supervision of the Ministry of Finance—will act as the Paying Authority for all Structural and Cohesion funding.

These authorities will also be responsible for (1) verifying that management and control arrangements have been set up and are being implemented, (2) submitting to the Commission with a description of these arrangements, (3) certifying that the declarations of expenditure presented to the Commission are accurate, (4) keeping the Commission informed of the progress of administrative and legal proceedings. Failure to comply with any of the above applications may prompt the Commission to reclaim part or all of the assistance granted.

Apart from the general Structural Funds Regulation, there are a number of more detailed Commission Regulations and procedural rules describing how the responsibilities of the different authorities have to be carried. Together, these rules establish a quite complex system for managing EU assistance. No wonder that most member states are having considerable problems in drawing down assistance merely because of the financial and administrative regulations in place.
Value for Money and EU support

While each beneficiary country has a vital interest in drawing down all available development assistance from the Community budget, the purpose of Cohesion Policy is not one of financial equalisation between richer and poorer member states, but the attainment of a specific set of development objectives, as described above, with the final goal of reaping the full benefits from existence of the Single European Market for all member states.

Accordingly, the regulations governing the operations of EU funds place great emphasis on ensuring that assistance is not merely spent, but that it has the desired effect. On the one hand, the work of the Monitoring Committees is supposed to ensure that any programme or project that is not implemented according to schedule, or does not deliver its objectives, is either adjusted or stopped altogether. On the other hand, independent evaluations—both on a regular and an ad hoc basis—are supposed to draw lessons from practical experience, and taken as a basis for remedial action as well as the design of future assistance programmes. The basis for all monitoring and evaluation work is establishing the proper factual basis for the review of programme performance. On the one hand, each member state is supposed to set up a comprehensive information system capable of processing the above information.

The second major challenge is related to programming. Well-designed programmes not only have a clearly structured hierarchy of objectives. For each of these objectives they also contain at least one monitoring indicator, which is “SMART”, i.e. one that

- has a specific relevance to the objective in question,
- is clearly measurable,
- available for regular performance checks at no disproportionate cost,
- realistically achievable within the framework of the programme, and
- applicable for the time period of the NDP.

The selection of such indicators is a cornerstone of good programming. Unfortunately, it requires considerable effort, and was therefore often omitted in the framework of pre-accession assistance programmes such as PHARE.

As described above, the regular follow-up of programme performance is provided for in the Monitoring Committees. The compilation of annual reports on all OPs and every EU financial instrument is another obligation for all beneficiary countries. Furthermore, each programme financed by the Structural Funds has to undergo at least a mid-term and a final ex-post evaluation, performed by external evaluators. The long process of external evaluations—already a regular practice in pre-accession aid programmes—usually starts with the compilation of an annual evaluation programme.

The main question of all assessments and evaluations is whether or not the project has reached its stated objectives. Thereby, the main focus is in the immediate objective (or purpose) of the project, measured by the relevant Indicators of Achievement. The question of whether or not the project was actually useful, must be assessed from the perspective of the beneficiary—which may be different from that of the Commission. The main criteria for all evaluations were summarised by the European Commission are relevance, efficiency, effectiveness, impact, and sustainability.
As regards programming:
• Was there a clear overall government policy framework, or strategy?
• Were the programmes or projects well planned?
• Did the government take the decisions for the implementation of programmes and ensuring the sustainability of the results achieved?

As regards partnership:
• Were the partner institutions sufficiently committed to the project?
• Was the project able to attract the interest of the target group and eventual further partners?
• How did the EU and national authorities co-operate?

As regards implementation:
• Did the implementing agency possess the resources necessary?
• Did the implementing agency work well?
• How was the performance of the Commission Services?
• Was the tendering and contracting process implemented successfully?
• Did a quality control mechanism overseeing the performance of contractors function?

As regards co-financing:
• Was the programme able to generate sufficient co-funding?
• Were the resources promised by the beneficiary partners actually delivered?

Altogether, there are a number of instruments available both to the European Commission and the National Authorities to ensure that money is not only spent, but that it is well spent. The use of these instruments requires considerable skills and resources. While the relevant methodologies have been shaped by years of practical experience with different kinds of EU development programmes—not only those operating in the countries set to join the EU in 2004, the system still seems to be less than perfect from a Hungarian perspective.

The main problems are related to inadequate planning, as well as the lack of institutional and financial resources to apply the practice of regular monitoring and evaluations to all programmes and projects. Ultimately, one of the main lessons from the EU’s pre-accession assistance programmes in Central and Eastern Europe was the importance of increasing, perhaps radically, the amount of human and financial resources dedicated to the management of EU funds well before accession. As seen in current EU member states, the number of staff working directly on the implementation of Structural and Cohesion Fund measures may well be in excess of one thousand on the level of central government administration alone—a very important figure in Hungarian terms.

Challenges in the Financial Control/Audit Environment

The need for intensive institution building efforts does not only relate to the managing authorities, paying authorities and monitoring committees mentioned earlier. The authorities in financial control, programme or project evaluations also have to step up their capacities. In Hungary, the main bodies concerned are:
• The State Audit Office, as the country’s supreme audit institution, accountable only to Parliament, and capable therefore of implementing independent external evaluations on all development programmes using state funds;
• The Ministry of Finance, in charge of co-ordinating the institutional framework of financial control and evaluations in Hungary, and hosting the paying authorities for all Structural and Cohesion Funds;
• The Government Control Office, as the specialised internal audit and evaluation body of the Government, acting at the discretion of the Prime Minister;
• The functionally independent internal control departments of all ministries implementing EU-funded programmes or projects (budgetary chapters); and
• The internal control departments to be established in all Managing Authorities.

The actual question arises for the State Audit Office concerning the NDP in a way seemingly a little bit curious: should the Office audit the interdependencies included in this document, or not? To answer the question one has to examine two aspects: firstly, shall the NDP be submitted to the Parliament; secondly, which document will serve as a binding deed to the budget approved by the Parliament. As a reminder, to emphasize the importance of this question and the way it pulls the State Audit Office into the realm of policymaker, consider the following: (1) The NDP serves as a basis for further negotiations with the European Commission. This Plan has to be submitted to the European Commission; (2) Following negotiations between the two parties, this will become a Community Support Framework, and so forms the basis for the actual operational programmes in a country, which are then submitted by the Government to the European Commission; (3) It is also the Member State’s responsibility to outline the specific programme details in the supplementary documents. The operational programmes also include financing plans. This must contain the origin of the financial sources, thus the fixed amount of public money, which relates to the public budget.

The concern is whether the State Audit Office should audit the sound foundations of the NDP. The next phase, the Community Support Framework, will determine the bigger proportion of Hungary’s possibilities to form the basis of development policy. It is important to recognize that the label of NDP is not a real nation-wide development plan because it must be aligned with the objectives of the respective Structural Funds (thus it is a European Union-influenced development plan). The scope of the objectives set by the EU is necessarily much more narrower than a possible large-scale national plan.

Financial corrections to the Structural Funds

There are very strict rules for the management of the financial assistance granted under the Structural Funds. Not taking into account all the aspects of the EU regulations that apply here, the detailed rules of the financial corrections tend to be stricter and stricter in order to improve the use of money once committed and made payable. The most important components required to fulfill are as follows:

1. Each Member State shall ensure the requirement to sound financial management of the Structural Funds in accordance with generally accepted principles and standards. It involves an adequate separation of functions for effective management and control systems concerned.
2. Member States should provide a so-called audit trail consisting of different parts for transparent accountancy, reporting system, and financial control.
3. The certification of expenditure is prescribed for every project.
4. Member States should maintain effective management and control systems which permit—among others—sample audits on operations in a detailed and well-defined manner.
According to the recent EU rules the Member States are responsible for using about 90% of the general budget of the European Union. Therefore the EU regulations require Member States to make financial corrections in connection with irregularities, let them be individual or systemic, by cancelling all or part of the contribution granted. Cancelling all or part of a contribution depends on the nature and gravity of the irregularities and the financial loss to the Funds. The secondary responsibility for the correct use of Funds is given to the European Commission. The sanction imposed on a Member State due to irregularities are aggravated in case of any delay in effecting payments.

If one takes into account that the financial assistance from the Structural Funds are linked with a certain proportion of additional national funds, the financial corrections on behalf of the European Commission can indicate lots of measures taken by the authorities. There is no doubt that profit lost in terms of infrastructure and other investments can effect the national economy more profound than reclaiming money from the direct or intermediate beneficiaries. Losses due to irregularities or misuse can occur mainly owing to the inefficient or negligent management, or other weaknesses in the internal control mechanisms.

**The audit scope of the State Audit Office of Hungary**

The State Audit Office of Hungary, as the supreme organ of state audit, has general authority with regard to its scope of duties. It applies to both the state budget and the internal control mechanisms within the government agencies. The State Audit Office audits the management of the state budget, and within the framework thereof, the foundations of the state budget proposal (and the supplementary budget proposal if there is any) and the feasibility of the revenue appropriations, as well as the regularity and economy of resources utilisation. Also, its task includes auditing the final accounts on the execution of the state budget.

In the present preliminary phase one should take into consideration the possible scope of an audit, or better to say, of forming an opinion on the plan. To form an opinion means also an audit in the technical vocabulary, since the auditors should verify the figures and relevant information as well as the supporting evidences as in the other instances.

The possible parts of the scope of an audit might be:

- assessing the adequacy and compliance to the EU requirements;
- whether the plan includes the specified proportion of co-financing from Hungarian funds (central and local budgets, credit, private capital, etc), and whether these figures are available in the future, as well as the enforcement of the additionality principle; and
- whether the operational programmes will guarantee to attain the targets set.

Beyond the scope of the audit there is an uncertainty in selecting the subject, namely what document is suitable for auditing, and what is the right way to follow in starting this work. If there was no time constraint—the NDP is to be submitted to the European Commission by 31 December 2002—there would be a good option to audit it along with the bill on the state budget. Another point is whether this document will be submitted to the Parliament for consent, or not. If yes, the Audit Office is supposed to form an opinion before. However, as it seems for the time being, this document will not be submitted to the Parliament, consequently only one option remains: the Prime Minister could invite the President of the State Audit Office to audit it.
The second phase in developing the NDP is the Community Support Framework after having negotiated the targets and relevance of the supporting set of information and financial plan. This will be the final document that must be the subject of auditing by the State Audit Office. Later, the accomplishment of the operational programmes will be the subjects of the State Audit Office’s audits both in the form of individual audit tasks, and incorporated in the budgetary chapter level financial audits. These ideas reflect the Audit Office’s way of thinking considering the constitutional and legal measures as well as the suitable solutions in order to prevent Hungary from major failures, and to minimize the risks in accomplishing the operational programmes.

Summary

To sum up, the accession to the European Union has been a long and difficult process for all the Central and Eastern European Countries (CEEC). The prospect of benefiting from the European Union’s Structural and Cohesion Funds was by no means the prime motivating force for these countries to strive for membership at the earliest possible date. It is certainly one of the important positive aspects of joining the Union, but it is not more than an opportunity. Whether or not Hungary and the other CEECs can use that opportunity well, remains to be seen. But the way in which they answer to the challenge will be of decisive importance for their future economic development. The positive answer is a must. It includes minimizing the risk in this very difficult implementation and control environment. The State Audit Office of Hungary wants to contribute to this goal efficiently, and this article has discussed some of the complications it faces in doing so.
Prioritizing Challenges in Improving the Use of Public Spending

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The World Bank

(The views expressed in this paper are those of the authors only. They do not necessarily reflect the view of the World Bank.)

Introduction

Common public expenditure management problems relate to questions of both ‘how much’ money governments spend and ‘how’ governments spend money. These have been called level-1 fiscal discipline, level-2 spending efficiency and level-3 spending effectiveness objectives, which are difficult-to-reach—especially in developing countries plagued by poverty. Such countries face resource deficiencies and uncertainty regarding resource flows, problems that make fiscal discipline vital but yield discipline-related goals difficult to attain. Similarly, while these countries acknowledge the need to allocate and spend resources efficiently and effectively to meet the urgent demands of the poor and ensure that public expenditures play a major role in reducing poverty, there are many more questions about how this should and could be done than there are answers.

The fiscal discipline, allocative and managerial efficiency objectives pose what could be called ‘macro challenges’ to governments, and particularly to professionals in the public financial management (FM) process—constituting the ‘end goals’ of financial management activity and reform. Most would agree that the public financial management domain faces a set of ‘micro challenges’ that require attention if these objectives are to be met. What we mean by ‘micro challenges’ are those pertaining to the many elements of the public financial management process, including but not limited to challenges to improve planning, budgeting, accounting, procurement and auditing practices and processes. In the face of the many such challenges, which are often dealt with in a piece-meal fashion, the question we are asking is: ‘How can we prioritize these challenges in the interest of improving the use of public spending?’

The approach we take to the question involves applying a form of systemic risk management to analyze public sector financial management processes. Common risk management focuses on mitigating external and/or inherent program risks through the use of insurance or by avoiding risky programs. A systemic risk is defined as anything within systems and processes that creates or suggests a hazard or impediment or threat to the achievement of an objective. As defined, systemic risks are apparent in all government systems and processes, and particularly within financial management processes. We believe that the process of identifying and assessing systemic risks as they pertain to the many facets of financial management is an effective one in pointing out where ‘micro challenges’ exist within such processes and developing a highly prioritized plan of action to meet such. This approach can best be described as a ‘risk and opportunity management methodology’ for identifying and prioritizing reform challenges in the financial management processes in place in high-poverty countries.
Risk management benefits to public sector
FM reform prioritization

‘Risk management’ has traditionally been viewed as a narrow, highly compartmentalized function in organizations, associated with “Health and safety management, fire protection, security, internal audit, insurance and business continuity planning.” In recent years an expanded approach to risk management has seen private sector professionals integrating discussion of threats and potential losses into core management processes, including strategic decision-making, financial management, procurement and auditing processes. This version of risk management is seen as crucial to most corporate governance agendas. Firms that manage their processes, and focus their process improvements, around risk mitigation find that the approach facilitates more effective strategic planning and decision-making, better cost control and resource use, improved shareholder value (through loss minimization and opportunity maximization), increased knowledge and understanding of exposure to risk and an ability to minimize disruptions associated with such, increased preparedness for outside review and the creation and strengthening of a culture for continued improvement.

Following on the increasing popularity of this kind of risk management as a tool for ‘managing’ in the private sector, the adoption of “a formal approach to the management of risk” is being seen as “a key element of international public sector reform.” Porter describes the potential benefits of using a risk management approach in governments: “Learning how to effectively manage risks to the achievement of departmental objectives provides managers with a systematic way to make responsible, informed decisions and enables them to achieve improved outcomes. A structured approach to the management of risk...enhances and encourages the identification of greater opportunities for continuous improvement through innovation.” Building on Porter’s sentiment, we believe that risk management, when focused on identifying weaknesses in core processes, offers a number of benefits to public sector financial managers dealing with challenges to improve the use of their expenditures:

• Risk management complements the goal orientation of the performance management movement and facilitates highly strategic managerial decision-making, particularly as such pertains to decisions to reform or improve critical processes (like the financial management process).

• The risk management approach can yield specific, detailed, decentralized and ongoing financial management reform suggestions and practice. These are considered more likely to be relevant to public organizations attempting reform, and more likely to be implemented as well.

• Risk management automatically gets managers to think about financial management reform sequencing (what should be done, when and in what form).

• Risk management improves the basis for internal control and monitoring as well as facilitating the creation of incentives for reform. Risks and plans to deal with such are identified in risk management processes, giving auditors clear insight into what entities do, what they see as their weaknesses and what they are doing to address such.
Identifying and prioritizing FM challenges using risk management

Managing risks governments face as they attempt to improve the use of public spending, especially in light of poverty-related challenges, involves both overcoming threats and identifying opportunities in everyday activities. A standard, though simplified risk management approach involves four steps:

1. Identifying public FM goals in such situations,
2. Listing the significant risks associated with each goal and evaluating such risks,
3. Developing action plans to manage, prevent and mitigate each risk as well as control activities to ensure that actions to manage the risk are carried out in a timely and efficient manner, and
4. Determining residual risk exposure and its possible effect on potential goal achievement.

Through these steps, we believe governments will be able to effectively identify, prioritize and address the challenges they face in trying to improve the quality of their spending. We also see the process as being vital in supporting international trends towards the adoption of a performance-based approach in the public FM domain and enhancing the value of government operations—in many ways the process of understanding risks to performance is the same as that of understanding performance targeting and management itself.

Identifying FM goals in high poverty settings

Risks are context-dependent, arising in relation to specific goals or objectives being targeted; identifying risk is thus only relevant within the context of clearly communicated and understood goals. Such goal focus is highly appropriate in the context of this paper in that FM reforms and improvements in the public sector are also goal-centered (or should be). Identifying goals is also an appropriate starting point for financial managers attempting to develop a reform agenda, as it forces thought on the objectives governments are trying to achieve and how FM practices and processes fit into such. In many cases FM systems and reforms to systems have failed because of a lack of clarity regarding the relationship between reforms and government objectives.

Identifying public sector FM goals is a difficult task, as there are potentially many. As introduced, however, three generic goal types have been identified in the public FM literature; level-1 fiscal discipline goals, level-2 allocative efficiency goals and level-3 managerial efficiency goals. Cast in the context of high-poverty settings, these three generic goals require governments to:

- Maintain a targeted level of fiscal discipline, as determined by specific deficit and debt targets and expenditure control,
- Allocate fiscal resources to programs and projects that are strategic to the poverty reduction process,
- Spend resources efficiently in strategic programs and projects, maximizing the value of the funds disbursed and the impact of the spending on poverty reduction.

Box 1 shows a basic approach financial managers can use to identify the FM goals of their own governments. Managers are required to move beyond the generic FM goals to detail, prioritize and specify different aspects of the objectives to reflect country-specific focal points.
Box 1. An approach to identifying FM goals in high poverty settings

Stakeholders from various professional backgrounds (accountants, economists involved in budgeting, planners, forecasters, auditors, etc.) should be asked, in a round-table setting or through surveys, to identify a prioritized list of specific government goals in the following three ‘goal’ categories (with prompting questions):

**Fiscal discipline**

What are the deficit goals of your government? Do you face any debt limits? Do you face any balanced budget requirements? Are there any goals you have in terms of the size of expenditures? Are there any goals you have in terms of the size of revenues collected? Is your government particularly focused on controlling expenditures in any specific area (be it a line item or a program)?

**Allocations quality**

What are the developmental goals of your government? Does your government have a plan that prioritizes where money should be spent? Where are the priority areas? How much money is allocated towards these areas?

**Spending efficiency**

Does your government have any efficiency targets when it spends? Are there any goals in terms of expenditure costs and/or quality?

We believe that the three goals are inter-related and need to be pursued in tandem to facilitate improvements in the use of public spending, especially in high poverty settings. Fiscal discipline is enhanced when governments think carefully about where and how efficiently they spend their resources. Similarly, and especially in high poverty settings where resources are scarce, the quality of expenditures is enhanced when governments spend in a disciplined fashion, ensuring that interest payments and such do not overwhelm resource bases or that private resources are not too severely crowded out by public spending. Even when treated as co-dependent goals, however, the goals are considered difficult-to-achieve. Threats to such achievement arise from external influences as well as complexities associated with the goals themselves and problems with common FM systems.

These problems could be called risks associated with FM goals, factors creating or suggesting a hazard or impediment or threat to the achievement of either or all objectives related to the use of public resources (fiscal discipline, allocative efficiency and managerial efficiency goals).

**Identifying and evaluating risks to achieving FM goals**

The main risk types affecting public FM goals in high poverty settings are external, inherent and systemic risks. External risks relate to perils, accidents, and hazards that impact governmental goals and are largely beyond the control of financial managers but require mitigation through insurance programs and such. Among the different types of this risk one finds economic, production, environmental, social, and political risks. These are typical focal points of traditional risk management activities. Inherent risks relate to the nature of spending tasks, defined by the United States General Accounting Office (GAO) as the risks emerging when “the nature of a program creates susceptibility to fraud, waste and abuse.” Managing these risks involves identifying spending programs that are ‘high risk’ and ensuring that these are either curtailed or developed with caution. Unfortunately, governments in high-poverty settings face
these risks with most programs they pursue (as most social and development programs are risky and susceptible to waste and fraud).

A third risk type, systemic risk, arises when the “programmatic, management support, or financial systems, policies, and procedures established by an agency to carry out a program are ineffective, creating a material weakness.”5 As they relate to the public financial management sector, these are the risks that arise when established FM practices and processes “create a material weakness” and threaten the achievement of FM goals. These kinds of risks arise throughout the FM process in developing countries, as shown in figure 1.

<table>
<thead>
<tr>
<th>Risks arise in the stage...</th>
<th>Risks arise regarding the connection...</th>
<th>Risks arise in the stage...</th>
<th>Risks arise regarding the connection...</th>
<th>Risks arise in the stage...</th>
<th>Risks arise regarding the connection...</th>
<th>Risks arise in the stage...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government planning and prioritization:</td>
<td>Budget formulation:</td>
<td>Program identification and design, prioritization, allocation</td>
<td>Budget execution</td>
<td>Disbursement, Monitoring, procurement, payroll, accounting</td>
<td>Reporting:</td>
<td>Financial reporting, auditing</td>
</tr>
<tr>
<td>Macroeconomic, Social, Anti-poverty</td>
<td></td>
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<td></td>
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</tr>
</tbody>
</table>

The figure shows the FM process as composed of four stages: planning and prioritization, budget formulation, budget execution and ex-post reporting (with connecting mechanisms between each stage). Systemic risks (whereby parts of this financial process are “ineffective” and create a “material weakness”) arise in all four stages. Systemic risks also arise in regard to the connecting mechanisms between stages. These risks are the focus of this paper, given the intended goal of identifying and prioritizing FM challenges in improving the use of public spending.

Systemic risks can be identified by asking a simple question, “What aspects of the FM process cause concern for goal-minded managers?” The question should be asked of managers in all the different stages, representing different disciplines such as planning, budgeting, accounting, and auditing. It should also be asked of managers in line departments and agencies to ensure that concerns are voiced regarding the static stages in the process as well as the dynamic connections between stages. These parties could be bought together in a practical round-table session, in which ‘concerns’ are voiced and recorded. They could also be asked the question through surveys. Box 2 provides a basic format managers can use to elicit responses.
Box 2. An approach to identifying systemic FM risks in high poverty settings

List the concerns (in no set order) you have about the ability of current FM processes and practices to facilitate the best use of public expenditures, as related to the following goals. List concerns as they pertain to specific stages in the FM process, and connections between stages.

For each goal area:

What concerns do managers have regarding FM practices and processes, as they affect the achievement of goals:

1. In the planning and prioritization stage
2. In the connection between planning and budgeting
3. In the budget formulation stage
4. In the connection between budget formulation and execution
5. In the budget execution stage
6. In the connection between budget execution and ex-post reporting
7. In the ex-post reporting stage

When identified in such fashion, systemic risks bought to attention of public sector financial managers are likely to be applied and specific to the entities involved—facilitating internal identification of reform challenges. The list of such risks is also likely to be long, to represent different perspectives in the FM process, and to include a number of surprises across professions (with accountants raising concerns that differ from budgeters and planners raising concerns that accountants may not have considered, for example). Examples of commonly identified systemic risks to the achievement of fiscal discipline-related goals relate to the following kinds of concerns:

- Is the budget drawn up on the basis of erroneous revenue and expenditure forecasts?
- Are the costs of proposed programs properly calculated or are there unseen costs?
- Do accounting systems in place in line departments accurately show cash flows?
- Will line departments run into unanticipated costs in the procurement or payroll processes?

Examples of commonly identified systemic risks to ensuring that expenditure allocation decisions are of a high quality relate to the following kinds of concerns:

- Do our strategic plans really focus on poverty reduction?
- Do our plans really drive budget formulation?
- Are our expenditure processes transparent?
- Do our street-level activities reflect our strategic plans and/or budgets?
- Can we judge the poverty reduction impact of public expenditures by examining our financial reports?

Examples of commonly identified systemic risks to the achievement of managerial efficiency-related goals in high poverty settings reflect the following kinds of concerns:
• Are the programs we choose really the lowest cost way of achieving our goals?
• Do program managers spend money in the most cost effective ways?
• Do program managers produce services at high quality levels?
• Are we wasting precious resources in procurement and payroll expenditures?

The United States GAO provides an interesting example of systemic risk identification within the context of more traditional program risk identification. The organization identifies material risks government-wide and in individual agencies relating to both inherent risks emerging in specific programs and to systemic risks related to program administrative and budgeting processes. The Internal Revenue Service receivables program was identified as inherently risky by the GAO, for example. Within the program, systemic risks were identified as they related to concerns over the tax collection process and mechanisms used to ensure compliance. Broader GAO concerns over weaknesses in key government processes have led to the identification of systemic risks related to technology management, basic financial accountability controls, program management practices and procurement in other agencies as well.

Assessing the need to respond to risks: prioritizing challenges

The GAO risk identification process results in the detection of many concerns, related to both the inherent and systemic problems of certain spending programs. A systemic risk identification exercise by financial managers in high-poverty settings is also likely to result in the identification of many risks. Managers have a vast and varied array of concerns about the potential of their financial management systems to meet defined goals. Faced with this host of challenges, key questions that risk management assists reformers in answering are, "Which risks should we respond to?" "When?" and "How?"

The first two questions relate to the issues of prioritization and sequencing. These are major issues for reformers in high poverty settings where there are many problems in the FM process. They are also relevant to private sector management trying to improve business practices at the margin. Just as private business-people need to know where to start with business improvement practices, public sector reformers need to prioritize their reform challenges to ensure that change is achieved where it is most required. Systemic risk management facilitates such prioritization, through analysis of risks arising in established processes using criteria relevant to reform decision-making.

Common criteria employed in risk management processes are the likely incidence of risk and the risk impact. While there are complex procedures available for managers attempting to assess the significance of specific risks, a simple approach involves evaluating identified risks with a score on each criteria. This kind of assessment could again be done in a round-table setting (where managers gather to determine the incidence and impact of all risks identified in the first stage of the analysis). It could also be done via a second round of risk analysis surveys, wherein managers are asked to perform the same task through a survey and results are collected and analyzed centrally.

Table 1 shows results of such analysis (based on a fictional case) to prioritize threats associated with some risks to the achievement of high quality allocations. We ascribe a value out of 5 on each of the two criteria (a score of 5 reflects a high risk incidence and a high risk impact and 0 means a low risk incidence and impact). The scores are combined to one value, indicating an aggregate risk
assessment that could be used to prioritize risks. It is important to note that this kind of score ascribes equal value to concerns over incidence and impact.

<table>
<thead>
<tr>
<th>Table 1. Assessing systemic risks</th>
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</thead>
<tbody>
<tr>
<td><strong>Risks</strong></td>
</tr>
<tr>
<td>• Budgets are not driven by strategies developed in the planning stage</td>
</tr>
<tr>
<td>• Budgeters are given few program options when setting budgets</td>
</tr>
<tr>
<td>• Costs of alternative budget options are not properly calculated</td>
</tr>
<tr>
<td>• Budget decisions are not disciplined by budget constraints (on revenue raising or on expenditures)</td>
</tr>
<tr>
<td>• Budget figures are not published</td>
</tr>
</tbody>
</table>

Table 1 sums fictional perspectives that assist in prioritizing systemic risks associated with the ‘allocations quality’ FM goal. Values in the table indicate that managers believe there is a high incidence and impact associated with the risk that budgets are not driven by strategies. This risk emerges as a ‘10’ on the priority rating, the highest priority possible—indicating that managers should definitely address the challenge associated with it. In the GAO, such risks are either called ‘material weaknesses’ (if they pertain to the Federal Government in general) or ‘performance and accountability challenges’ (if they pertain to individual agencies). It is interesting to note the link in the terminology between the risks identified and performance management practiced in the government. On the other extreme, Table 1 shows that managers scored a combined 2 for incidence and impact related to the risk ‘Budget figures are not published’—indicating that this risk is not considered pressing and should be given low priority when devising a reform strategy.

The exercise could culminate in providing some kind of graphic presentation of risk priorities, as in Figure 2, which shows the evaluation criteria on two axes. This kind of analysis allows one to emphasize one of the criteria over the other. If ‘high impact’ risks are considered high priority even when their incidence is low, for example, four kinds of risk can be identified:

• High priority risks (high incidence and high impact risks—they happen a lot and pose significant threats),
• Secondary priority risks (low incidence but high impact risks—they may not happen a lot, but when they do they are serious),
• Tertiary priority risks (high incidence but low impact risks—they happen often but don’t pose significant threat), and
• Low priority risks (low incidence and low impact risks—they have a low chance of occurring and even when they do, their impact is low).
Obviously, the risk that budgets are not driven by strategies sits in the ‘high priority risk’ quadrant (scoring a ‘5’ and a ‘5’ on the two criteria), while the risk associated with budget figures not being published is located in the low-priority risk quadrant (scoring a ‘1’ and a ‘1’ on the two criteria). Other connections between the figure and the scores in Table 3 should be apparent (some are included to show the interaction between the two).

**Figure 2. A graphical presentation of risk priorities**

<table>
<thead>
<tr>
<th>Risk impact</th>
<th>Secondary priority risks</th>
<th>High priority risks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Budgeters are given few program options when setting budgets</td>
<td>• Budgets not driven by strategies developed in the planning stage</td>
</tr>
<tr>
<td></td>
<td>• Budget figures are not published</td>
<td>• Costs of alternative budget options are not properly calculated</td>
</tr>
</tbody>
</table>

This kind of risk evaluation and prioritization process can be criticized for not being purely scientific, but it does provide a better approach to challenge prioritization than most countries currently have, and it is both practical and meaningful. It gets reformers and managers thinking hard about exactly how they need to manage to achieve objectives, and which problems pose the greatest threat to such achievement. Box 3 sums up a basic approach to this process.
Box 3. An approach to prioritizing systemic FM risks in high poverty settings

Approach 1.

Go through the list of concerns you have about the ability of current FM processes and practices to facilitate the best use of public expenditures, as related to the fiscal discipline, allocations quality and spending efficiency goals within your government. Assess the likelihood of the risk occurring (its incidence) between 0 and 5 (where 0 means it is guaranteed not to happen and 5 means it is guaranteed to happen). Then assess the impact the risk will have on the goal in question, if it does happen, between 0 and 5 (where 0 means no impact and 5 means that it will totally negate any possibility of achieving the goal). Sum the two scores up into an overall score and order the risks in a table, from highest overall score to lowest overall score. Risks at the top of the table are the highest priority risks, and demand first attention.

List of risks related to each goal.
Risk
Incidence score
Impact score
Overall score

Approach 2.

Once scores have been given for the incidence and impact of each risk, plot the position of each risk on a four quadrant graph (as below). Risks in the top right corner are the highest priority risks demanding first attention. Risks in the top left hand corner may not arise often, but when they do they can compromise goal achievement—thus they require attention as well. Lower impact risks could be treated as lower priority risks.

Risk impact

<table>
<thead>
<tr>
<th>Risk impact</th>
<th>5</th>
<th>High priority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk incidence</td>
<td>0</td>
<td>5</td>
</tr>
</tbody>
</table>

Choosing and implementing reforms to address prioritized systemic FM risks—or FM challenges—is a difficult process. Commonly, governments invite external agencies to drive such process, adopting broad-based ‘best practice’ approaches to change that seldom succeed. The current risk management approach offers an alternative process of public sector FM reform selection and implementation, based on the preliminary identification and prioritization of specific weaknesses—logically seen to affect end goals—requiring attention in governments. Such identification and prioritization allows governments to:

- Link their reform identification and implementation process directly with their ultimate goals (related to poverty reduction, for example), thus integrating reforms into overall performance management processes.
- Have a more focused and continuous reform identification process, in which internal and external entities are called upon to offer potential solutions to risks (yielding more innovative, specific ideas that enjoy higher managerial acceptance—an important factor explaining reform implementation success).
- Develop reforms that have measurable objectives—the alleviation of risks. These objectives form a defined purpose for reformers and constitute the basis for evaluating reform success (and integrating reform processes into larger managerial systems and objectives).

Governments can choose a variety of reform approaches to deal with systemic FM risks. The most common are reforms focused on risk prevention and risk mitigation. Risk prevention involves “reducing the possibilities of an undesired event” while risk mitigation entails “reducing the consequence of an undesired event.” Reformers need to decide which approach they wish to take regarding each risk identified. Decisions could vary according to different risks. For example, in the fictional case shown in Table 1 we identified two high priority risks to allocations quality as “Budgets are not driven by strategies developed in the planning stage” and “Budgets are dominated by ‘base expenditures.’” In the first instance reformers might seek a solution that prevents the risk completely, attempting to alleviate any chance that budgets are not driven by strategies. In the second instance reformers might attempt to deal with the risk by mitigating it, arguing that in the short run budgets will be largely dominated by base expenditures, so the challenge is to ensure that these expenditures are related to strategies—ensuring high quality allocations.

Identifying reforms on such a specific basis constitutes a departure from the current practice of adopting large-scale reforms aimed at improving financial management processes generally. There is still, however, potential for adopting large-scale reforms, but only insofar as they relate to specific risks identified. A good example is the Medium Term Expenditure Framework (MTEF), which could be seen to address identified problems of budgets not being driven by strategies, of budgets not being classified in a manner that reveals priorities and of the budget formulation stage being non-transparent. A MTEF could be introduced to prevent or mitigate the individual risks identified (the reform is not the goal itself). This would mean that identification and implementation of individual aspects of the MTEF—like the medium term budgeting dimension or the assignment of programs in MTEF or the publication of Medium Term Budget Policy Statements—would be more important than the overall ‘MTEF reform’.

Evidence suggests that focusing on ‘micro challenges’ and details of reform as they pertain to weaknesses in FM systems is a more effective way of approaching reform than adopting large scale initiatives. Studies on the influ-
ence of balanced budget requirements, for example, show that differences in reform details determine whether balanced budget requirements are ‘strong’ or ‘weak’, with only ‘strong’ reforms actually influencing budgeting behavior and outcomes. Similarly, studies of performance-based budgeting (PBB) in the US states indicates differences in the details of PBB reforms. For example, differences in publication practices (some publish and others don’t) and monitoring practices (some monitor and others don’t) determine the reform’s effect on expenditure levels. Essentially, when specific reform components are targeted at specific weaknesses and risks, they are more likely to be effectively chosen and implemented.

The basic approach to integrating reform selection into the systemic risk management process thus starts with matching high priority risks with potential reform ideas. Once this is done the anticipated impacts of reform options should be analyzed (on the risk in question as well as on other risks, so-called external reform benefits) and the reform options should be costed. As with the previous two risk management steps, the best approach to this exercise would involve hosting a round-table discussion of reform options pertaining to the risks prioritized. There could be a number of these discussions (held by specific agencies who will ultimately be responsible for specific reforms, for example). The aim is to establish a reform plan of action to deal with high priority risks.

Costing FM reform and improvement options is integral to making reform decisions as part of everyday management (given that reform involves developing responses to FM challenges, which are continually evident). Costing reform options allows for budgeting of reform decisions. The risk literature stresses the importance of budgeting for risk mitigation. Hulett says, for example: “A risk-mature organization will budget and schedule risk mitigation actions…In some organizations that have not achieved a high-level of risk maturity, the Risk Register is populated with actions that are proposed but not funded. One measure of an effective risk management process is if mitigation actions are “agreed”…and an indicator of agreement is if funding backs up the actions.”

The importance of budgeting for reform links into an area of risk management sometimes termed ‘control activities’. These relate to activities risk managers introduce alongside risk mitigation strategies to ensure that such strategies are implemented. They include requirements for information on detailed reform actions (showing what is being done to deal with the risk), the reform budget (showing the material commitment to reform), reform dates (showing definite reform plans), reform monitoring goals and reform monitoring dates (facilitating evaluation of reforms). Such requirements are meant to facilitate monitoring and auditing of reform progress (something which is seldom done). They also allow for the introduction of incentives to stimulate reform implementation and risk alleviation (again, a neglected area in reform).

The GAO introduces requirements like these into steps government agencies have to take (and criteria they have to fulfill) to be taken off the high-risk designation list: “Criteria agencies must meet before high-risk designations can be removed:

• A demonstrated strong commitment and top leadership support to address the risk(s)
• The capacity (that is, the people and other resources) to resolve the risk(s)
• A corrective action plan(s) that
  • defines the root causes
  • identifies effective solutions, and
• provides for substantially completing corrective measures near term, including but not limited to, steps necessary to implement solutions we recommended

• A program instituted to monitor and independently validate the effectiveness and sustainability of corrective measures

• The ability to demonstrate progress in having implemented corrective measures.”

Requiring satisfaction of such criteria is meant to ensure that risks are dealt with. When met, the GAO is given an identifiable corrective action plan that they can actually monitor and audit. In such cases reform progress would be open to evaluation and audit, providing evidence of ‘performance’ in risk mitigation (and ultimately in removing threats to meeting final challenges themselves). Having such information is vital, especially in settings like the developing world where general agency performance is difficult to evaluate and audit (politically and practically). The information also facilitates the structuring of incentives for those charged with reform. The literature indicates that reforms often fail in implementation because of a dearth of such incentives. Willoughby and Melkers argue, for example, that there is a lack of leadership and acceptance in many performance-based reforms as well as “a lack of incentives or an inappropriate use of disincentives related to the conduct of performance measurement,” which “often shelve such reform attempts prematurely.”

Box 4 ties the processes of reform choice and reform control together to provide a simple approach to the task of selection reforms and responding to challenges to improve the use of public spending.

Box 4. A risk alleviation approach to matching FM reforms with FM challenges

The starting point for financial managers attempting to choose reforms is the list of high priority risks they have already identified. Managers should take this list and develop some ideas about reform and innovation options associated with each risk, deciding whether they are trying to prevent the risk altogether or just mitigate its effects. Managers should then assess the potential impacts of each reform option, for the risk identified as well as other risks (external benefits) as well as the costs of the reform option. On the basis of such analysis, managers should be in a position to make a reform choice (choosing the most effective reform within its reform budget).

Selecting FM reforms as they relate to high systemic risks in FM processes

Risk
Priority

Reform and innovation options
Anticipated reform impacts (and external benefits)
Reform option costs
Reform choice and budget

To ensure that reforms are undertaken that auditors have avenues for monitoring reform progress and that reformers have an incentive to deal with risks (through reform implementation), a number of controls need to be built into the FM reform and improvement plan. These should focus on each risk and should involve requirements for a reform budget, reform dates, reform monitoring goals and dates.
Control requirements associated with FM reforms
Risk

Priority

Reform action
Reform budget
Reform dates
Reform
Monitoring goals
Reform monitoring dates

Understanding (and reporting) the influence of residual risk exposure

The final step in a basic risk management strategy involves re-visiting the risk mitigation and prevention strategy adopted to assess the residual risk still faced. The goal is to develop a clear picture of the threats that still remain to the achievement of FM goals. In the private sector such a report of risk exposure is sometimes used to communicate information about threats on performance to stakeholders. The reporting process shows that management is aware of such risk exposure and can in some instances include explanation as to why management has not addressed such. In most instances these risks are external, related to market fluctuations and natural calamities. In some instances these risks are inherent to products being produced or to internal processes (systemic risks) that are not addressed because of a lack of resources to do so. Regardless of the reason for continuing exposure, management shows an understanding of their situation and is transparent about the lingering threats to performance.

This kind of exposure analysis and reporting is increasingly important in the public sector, as it relates to ‘value for money’ or ‘performance’. Executive entities responsible for managing fiscal resources need to show an up-front understanding of the factors that threaten fiscal performance so that the public (represented by legislatures) can question why threats are not countered and can ensure that performance targets are realistic (given these threats). Being up-front about risk exposure protects managers from the blame of poor performance bought on by the manifestation of risks they were always concerned about. At the same time it increases the value of agreed-upon performance targets, as managers cannot create after-the-fact excuses for poor performance. Such excuses would indicate poor up-front risk identification and management, itself an important part of performance management.

Conclusion

Risk analysis offers a mechanism for prioritizing challenges facing managers in the public FM process. Through such prioritization it also assists reformers in making specific decisions about reform implementation, and ultimately it also enhances the ability of reformers to monitor reform and create incentives to encourage reform.

We believe that this kind of risk-based approach to reform identification is particularly important in the public sector, as FM goals in this sector are both complex and difficult to achieve. Whenever goals face as many threats as the fiscal discipline, allocative efficiency and managerial efficiency FM goals, it is vital
to analyze these threats and focus process reforms on alleviating such. This kind of analysis is vital to identifying opportunities for improvement, and even for facilitating innovation as to how improvements can be effected. As such, we call the approach a “risk and opportunity management methodology.”

Such approach is increasingly being used to identify and focus activity agendas (whether they pertain to core operational activities or to reform activities) in the public sector. The approach often connects the public FM domain with larger issues of governance, including corruption and accountability, and yields the kind of benefits identified:

- The South African Public Service Commission has recently developed a risk management framework and policy for the Public Service. It requires departments to identify the risks they face, to assess the causes of these risks, the likelihood of their occurrence, and to prioritize these risks and formulate appropriate responses. This approach is aimed at infusing a culture of risk management throughout the Public Service and to enhance identification of causes for corruption and financial mismanagement.9

- The World Bank used a risk management approach to analyze problems in the public FM process in Bangladesh. They concentrated on issues including parliamentary control of public expenditure, public sector auditing, budgeting, accounting, reporting and internal control and local government FM.10 “The assessment concluded that the fiduciary risk in public spending in Bangladesh is high and recommended a variety of corrective measures,” with such recommendations facilitating reform prioritization.

- Another example comes from the United Kingdom’s Department for International Development (DFID), which recently published a report arguing that risk management can assist it in meeting its fiduciary responsibilities.11 The DFID publication implicitly argues in the same vein as the current paper, suggesting that risk management can provide a good approach to identifying problems with country financial management systems: “Risk management process[es] can be used to identify reform steps.”

- The GAO in the United States focuses on risks in its dealings with government agencies and departments. The GAO identifies high risk programs within agencies and (at an even closer level of analysis) processes, systems, and capacity areas where high risks exist. The GAO’s risk management approach emerged in response to trends evident globally that place “a premium on increasing strategic planning, using integrated approaches, enhancing results-orientation, improving responsiveness, and ensuring accountability within the federal government.”12
End Notes

1. This definition is adapted from that in Merriam-Webster’s Dictionary. It is also widely used in the risk management literature. An example is the recent paper adapted to ‘small public entities’ by Reiss (C.L. Reiss, Risk Identification and Analysis: A Guide for Small Public Entities (Fairfax, VA.: Public Entity Risk Institute, 2001), 1).


5. General Accounting Office (2000, 8).


9. This information comes from a speech by the G. Frasier-Moloketi, Minister for Public Service and Administration on the anniversary of the anti-corruption summit, as issued by the South African Government Information Communication Service in Pretoria, 14 April 2000. See also the Budget Vote Speech, 13 April 2000. Available at www.polity.org.za.


Pro-Poor Financial Management: The Development and Implementation of Poverty Oriented Budgets in the Wider Context of Public Sector Financial Management

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Introduction

The development agenda has over recent years increasingly focused on the reduction of poverty. This trend is evident in the actions of individual governments and donors, and the development of Poverty Reduction Strategy Papers (PRSPs), required for Highly Indebted Poor Country (HIPC) initiatives. This article addresses the financial management issues of pro-poor strategies. It goes beyond pro-poor budgeting to consider the broader concept of pro-poor financial management, embracing (in addition to budgeting, revenues, assets and liabilities) accounting and auditing, and the linkage to expenditure tracking and performance targets. The article starts with a discussion of poverty reduction strategies. It then moves to analyze specific areas in which financial management reforms are required to ensure an integrated approach to facilitate the development and implementation of poverty oriented budgets.

Reducing poverty, and recent financial management initiatives

Approximately 25% of the world’s population, some 1.5 billion people, live in poverty. It is infeasible that absolute poverty could be eliminated solely by income redistribution within countries or between wealthy and poor countries. Transfers from rich to poor countries even on a limited scale meet political resistance. Furthermore there is little evidence that income inequality in the third world has changed significantly over the last thirty years, though there is evidence of growing inequality in some first world countries and in the former Soviet Union countries. Therefore, elimination of poverty requires the income of poor countries to grow. To eliminate poverty by 2050 without changes in income distribution would require per capita income in the third world to grow by about 3.5% per annum in real terms. Pro poor strategies must enable income growth, whilst at the same time ensuring income inequalities as a minimum do not worsen and resources are allocated so as to benefit poor people.

Financial management reform, PRSPs and SWApS

Strategies to increase income generating capacity of poor people and strategies to enhance economic growth should be mutually reinforcing, e.g. improved primary education. However, there may be a conflict between growth strategies and strategies to increase consumption by poor people, e.g. improved sanitation improves consumption by poor people but does not generate income. Choices may have to be made between consumption and growth. PRSPs lead to a policy matrix of required actions. These may enhance consumption by poor people,
e.g. “Provide universal access to safe drinking water and to sanitary means of
excreta disposal ….”, or they may enhance the capacity of poor people to gener-
ate income, e.g. “Increase school enrolments by girls in the age range 9 to 11
from 30% to 70% ….”. Translation of policies into actions typically requires the
directed expenditures of public funds, and the mechanism for achieving this is
through budget allocations and budget execution. Therefore, PRSP implemen-
tation requires budget processes and systems that enable pro-poor policies to be
actioned, accounting systems that enable expenditure to be tracked, and audit
and accountability mechanisms that provide transparency. PRSP policy imple-
mentation is quantitatively monitored by tracking expenditure against agreed
budget lines.

The expectation is that sound public financial management associated with
PRSPs initiatives will support growth strategies, pro-poor strategies, and the
making of rational choices between alternatives. The relationships are sum-
marised in Exhibit 1 below.

Exhibit 1: Linkages between pro-poor strategies

Specific linkages between public financial management
and pro-poor strategies

Many target countries for HIPC and PRSP initiatives have inadequate public
financial management (often referred to by the narrower term “Public
Expenditure Management” or PEM). Of the 22 countries that had reached the
HIPC decision point by end-2000, 16 countries have identified needed improve-
ments in PEM systems covering the broad categories of budget formulation,
execution, and reporting, as completion-point triggers. Improvements in public
financial management are often a precondition for ensuring that governments
can budget for poverty reduction. The World Bank has summarised the goals of
public financial management in the PEM Handbook, and these are linked to
pro-poor strategies in Exhibit 2 below.
Exhibit 2: Goals of government financial management

<table>
<thead>
<tr>
<th>Goal</th>
<th>Linkage to pro-poor strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 1—fiscal management</td>
<td>Distributive impact of tax and non-tax revenue raising Impact of fiscal issues (resources, risk, shortfalls, etc) on pro-poor strategy and income vulnerability</td>
</tr>
<tr>
<td>Level 2—resource allocation</td>
<td>Fundamental to the concepts of pro-poor strategies is the ability to allocate resources in a directed manner through the budget process</td>
</tr>
<tr>
<td>Level 3—value for money</td>
<td>With limited resources in poor countries, obtaining value for money - efficiency, effectiveness and economy - in expenditure is critical. Embraces the need to avoid leakages through corruption or theft</td>
</tr>
<tr>
<td>Transparency</td>
<td>Fundamental to an enabling environment - make effective participation feasible, minimise opportunities for leakage, enhance the democratic decision process</td>
</tr>
<tr>
<td>Accountability</td>
<td></td>
</tr>
</tbody>
</table>

Implementing the above goals requires an effective public financial management system that facilitates the development and implementation of budgets that are evenly balanced to meet the needs of the poor. In order to develop the pro-poor financial management system a number of issues need to be addressed:

- Participation in the budget process
- A sector wide approach
- The budget classification
- Budget timeframe and Medium Term Expenditure Frameworks
- Cash management substituting for budget management
- Ability to translate budget decisions into actions
- Performance targets and their linkage to budget allocations
- Expenditure tracking and government accounting systems

*Participation in the budget process and the asymmetry of information*

An understanding of organisational relationships is fundamental to understanding how budgets are created and implemented, and the practical difficulties of implementing pro-poor strategies. Traditional “hard” organizational theory envisages the government establishing its goals and priorities, and then using the budget to turn these into actions subject only to fiscal constraints. Under this model, creating a pro-poor budget requires governments to identify appropriate strategies before they can do this, and to then incorporate these into the process.

A “soft systems” approach recognizes that the political process involves organisational entities - the government Departments led for budget purposes by Finance - responding to a range of stakeholders and organizational pressure groups. Government Ministers, though theoretically able to dictate policy, rarely have such unfettered authority, and typically neither agree amongst themselves, nor have adequate information. Donors, powerful interest groups and other...
stakeholders also influence government strategies. The concept of the asymmetry of information means that full information on the impact of decisions will not percolate to higher levels of government, and therefore broad policy decisions are often made without a detailed understanding of their effect or how they will be implemented.

This “soft” but more realistic model of the budget process recognises the above realities, and envisages a Department of Finance trying to manage the budget process to meet the needs of a range of stakeholders, and without detailed information on the outcomes that will result from resource allocation decisions. Within the milieu, poor people have traditionally had little influence and a very weak voice “… there is hardly any consultation with ordinary people.” One objective of pro-poor policies and their articulation through PRSPs is to give the poor, or their representatives, a greater voice in the budget process. Without such participation, other stakeholders will reassert their dominance over the budget process. Examples cited in Zambia illustrate how such a process works in practice, and the alternative models are illustrated in 3 below.

Exhibit 3: Hard and soft models of budget process
strated the use of a weighting system to resolve such conflicts. It is concluded that any pro-poor budget strategy must recognise the organisational complexity of the budget process, enable effective participation by poor people, and achieve accountability and transparency as fundamental to realisation of pro-poor strategies.

The budget classification

The Government budget is a legal instrument authorising the raising of revenues and the expenditure of public money. Budgets are organised first and foremost to achieve these national fiscal objectives. In almost all countries budgets are linked to an annual financial cycle. As a tool to allocate resources for pro-poor or other specific strategies budgets exhibit five limitations: (1) Budget organisation by administrative units rather than sectors; (2) Inadequate expenditure classification; (3) The annual timeframe, and particularly the lapsing of funds at the end of the year, are inappropriate for strategies that take several years to mature; (4) There is no guarantee that funds allocated in the budget will be spent as intended; and (5) expenditures are not easily linked to performance indicators. These limitations are each considered below.

1. A sector-wide approach

Budgets are typically organized to follow the administrative set-up of the government, and within a narrow definition of government, e.g. national ministries and departments. However, in order to assess resources being allocated for pro-poor activities, a sector wide approach is necessary. For example, in Lesotho a sector wide approach to the health sector had to embrace:

- Ministry of Health and Social welfare
- Lesotho AIDS Prevention Coordination Agency
- Ministry of Defence
- Maseru City Council
- NGOs, particularly Christian Health Association of Lesotho (CHAL)

This sector-wide approach does not fit with a traditional government budget system, yet to look at health expenditure in Lesotho without considering the expenditures by, for example, CHAL, would present an incomplete picture. Under Sector Wide Approaches (SWApS), all significant public funding for a sector supports a single sector policy and expenditure programme under Government leadership. Extensive benefits have been claimed for SWApS including a focus on the strategies and policies of government (fiscal discipline, allocation and efficiency); a focus on strengthening government institutions; the potential for simplification and harmonisation of aid procedures between donors and with it the potential to increase and accelerate aid flows; and to enable decentralisation. There is as little hard evidence of the extent to which such benefits have been achieved. One study concludes “There is a mixed picture on the extent to which the poor are benefiting…” However, there is evidence that joint reviews conducted as part of the SWAp analysis have sharpened the focus on poverty, and clearly a sectoral perspective provides a more rational resource allocation framework.

2. The budget classification

Traditional budget classification structures have followed government organisation structures, with expenditure further divided into economic categories, e.g. payroll, utility costs, capital expenditure, etc. This approach provides a matrix classification. Since Departmental organisations vary between countries, and titles often bear little resemblance to sectors, the International Monetary Fund (IMF) has sought to rationalise the organisational analysis by requiring all countries to provide statistics in accordance with a standard classification. In the latest edition of the IMF Government Financial Statistics (GFS) Manual there are some 62 functional classifications. Incorporation of these functions into the classification system will often cut across Departmental boundaries, and in
effect introduces a third analytic dimension, but is essential for a sectoral approach.

Nevertheless, adherence to the IMF GFS functional classification is still unlikely to be sufficient for allocating resources in accordance with PRSP strategies. For example the Zambia PRSP 2002 has as a health care priority “Integrated Reproductive Health” . This requires a programme structure below the level of the GFS functional classification. Yet in 25 HIPC countries surveyed by the IMF in 2001 only 9 even had a functional classification available for two years earlier, and “classification by program is rare”.

Functional and programme classifications appear to meet the needs of a PRSP, but in fact they have some quite fundamental flaws as poverty strategy management tools: (1) Functional classifications have no automatic link to management responsibility (since the latter are related to the government organisational structure), and in some cases there is no single management focus for programme expenditures. In consequence expenditures may be analysed in a manner unrelated to management control; (2) the programme level of detail is still insufficient for detailed management control, the building of activity cost models or allocation to geographic locations. Thus it is possible to have an analytic structure based on functions and programmes that has no direct link to organisational structures and management responsibilities.

What is required is a classification structure that is based on organisational structures and managerial responsibility, but that also enables analysis by functions and cross-cutting programmes. This can be achieved by an approach that disaggregates expenditure down to individual cost centers. Whilst this level of detail is not required for the national budget (and indeed would distract from policy issues in the budget), it is required for effective expenditure management. This approach fits with the concept of the asymmetry of information, referred to above, and the detail of establishing costs centres is better done within individual ministries rather than centrally by a Ministry of Finance.

The conclusions may be summarised as follows: (1) Of necessity, governments must classify their budgets organisationally and by economic categories, but this alone is insufficient for management or poverty reduction strategies; (2) IMF GFS functional categories provide a more detailed and standardised classification of expenditures, but are unlikely to be sufficient to either manage expenditures or to be linked to government organisation structures; (3) Programme budgets can be linked to pro-poor and other strategies, but are only effective management tools if coincident with management responsibilities; and (4) In order to properly manage and track expenditures, cost centre analysis is essential, but the cost centre structure and detailed resource allocation should be driven by individual organisational units rather than by a Ministry of Finance.

Such a structure is feasible. In Nepal as part of the budget system, a facility has been established for the Budget to be enacted to functional level, and then individual Ministries authorise spending at the more than 3,000 cost centres across the country. A model of this classification structure is provided in Exhibit 4 on the next page.
This model is perfectly feasible to implement in practice. Also, most accounting and ERP packages are geared towards cost centre accounting, and can handle the above analysis and use it to derive reports with different forms of aggregation. It will enable tracking of specific pro-poor strategies and can be linked to performance indicators (see below).

3. Budget timeframe and MTEFs

The annual budget cycle is inadequate for strategic resource allocations. Problems are the fact that most strategies take more than one year to mature, the need for certainty of funding, and the problem of funds lapsing. Most pro-poor and development strategies take a number of years to implement and for their benefits to be realised. Capital projects often extend over many years, and the impact even longer to realise. These time frames are much longer than the budget cycle, and trying each year to approve a slice of capital expenditure is technically difficult, and it fails to manage the project over its life cycle. One of the most difficult problems is the lack of certainty of funding, since unspent funds lapse at the end of each year, yet the timing of expenditures may be difficult to predict and affect by many exogenous factors.

Segregation of budget expenditure into Recurrent and Development budgets was intended to address the problem, with development budgets driven by a medium term development plan and public investment programme (PIP), but in practice development budgets have become little more than vehicles for development projects, often including some recurrent expenditure, whilst recurrent budgets are typically budgets for government salaries. A recurrent/capital division is clearer and more readily defined, but does not in itself address the issue of the budget timeframe.

A medium term (3 to 5 years) budget, usually referred to as MTEF does begin to address the issue, provide time for strategies to mature and some certainty of future funding. Whilst an even longer timeframe may be theoretically desirable, there is evidence that forecasts beyond three years rapidly lose reliability, and may detract from the relative certainly of a 3-5 year budget period.

MTEFs offer a significantly enhanced framework for implementing pro-poor strategies, but to be effective certain conditions need to be met: (1) The processes for preparing the MTEF and annual budgets must be integrated, preferably
within a sector wide approach; (2) MTEFs should be legally recognised as providing a framework for annual budgets; (3) The issue of lapsing of funds must be addressed. In responding to donor pressure for MTEFs, it is relatively easy for countries to prepare a MTEF after the annual budget is completed. Such an approach may provide useful analytic and forecasting information, but does not impact on the budget process itself. In Kenya, for example, there is a detailed medium term budget published after the annual budget, leading to a considerable volume of documentation. Yet this has proven ineffective at controlling off-budget expenditure, nor is the medium term budget an input to the annual budget process. Instead, the objective should be to fully integrate the annual and MTEF processes, so that the first year of the MTEF becomes the basis for the current year’s budget, and an extra year is added—a “rolling” approach, as adopted in Australia.

It follows from the above that there needs to be some legal status for the MTEF, so that it can be approved as part of the budget enactment process. Legal recognition forces clarification of the relationship between MTEF and annual budgets, and indicates a commitment to future spending plans. Such commitment and certainty of funding is essential for effective pro-poor strategies. Finally, the issue of lapsing of funds needs to be addressed within the MTEF context. The nature of government budget approval is that funds are voted for expenditure within a specified period of time, and if not spent “lapse.” This process, however, can very significantly distort government expenditure time profiles. For example, in Papua New Guinea, a high proportion of government expenditure takes place in the last two months of each financial year. Because a legal MTEF authorises expenditure over a number of years, it is feasible to devise simplified approaches for transferring funds inter-temporally between financial years. Again this can be very important for pro-poor expenditures, where the harvest cycle may be more important than the financial cycle.

A familiar pattern in poor countries is an elaborate budget process, often with extensive donor involvement, resulting in the enactment of a budget which is then largely ignored as funds are disbursed in response to immediate demands as cash becomes available, such process often managed by an internal committee of government officials. Funds are wired between expenditure heads, often only formalized retrospectively, and the actual allocations have only limited resemblance to original budget allocations. Zambia and Papua New Guinea provide examples of this situation. Cash management has substituted for budget management—but why does it happen?

The answer must be that the budget is unrealistic in forecasting resource availability or expenditure commitments, or some combination of both. Resource forecasting often fails to take account of debt flows or the impact of contingent liabilities crystallizing—cash accounting is especially weak because it does not recognize liabilities. Expenditure forecasting often fails to take account of committed expenditures, e.g. debt service, rentals, utilities.

When expenditures have to be cut under a cash management system, it is often pro-poor budgets that suffer most—it may be easier to cut expenditure on school books than on defense. Pro-poor budget management should ideally ensure that cash management is reduced to its proper role of managing timing differences in resource and expenditure flows, but where cuts are required pro-poor expenditures are ring fenced.
4. Ability to translate budget decisions into actions

There are a range of reasons why expenditures voted in the budget may not actually be expended. A common reason is that the budget vote may be a political device, for example in Nepal projects are regularly voted in the budget then "suspended" - the projects are in the budget to satisfy political pressures and there is no real intention of implementation. Further complicating matters is the general experience in which a complex bureaucratic process for the incurring of expenditure provides opportunity for pressure by interest groups, corruption, theft or simply inability to manage the process to result in funds not being spent as intended.

The expenditure procedures in most poor countries are excessively bureaucratic, and controls originally established to avoid corruption often end up by actually increasing the opportunities for such corruption, as well as creating inefficiency and delays in expenditures. There is no universal model of the expenditure processes, and even in English speaking countries the terms used have different meanings. Exhibit 5 below provides a simplified generic model, synthesised from several different countries.

Exhibit 5: Simplified generic model of expenditure processes

Typically, poor countries suffer form weak governance, and the above processes do not work efficiently. It is our experience that macro level designs rarely take account of these detailed issues, yet problems at this level are often a cause of reform strategies failing. There is often significant resistance to the reform of expenditure processes. Complex bureaucratic processes create employment, provide opportunities for corruption and enable interest groups within the bureaucracy to manipulate expenditure patterns. Yet unless these issues are addressed, pro-poor strategies will always achieve less than their full potential.

5. Performance targets and their linkage to budget allocations

Performance management represents an attempt to shift the focus of public sector managers (and politicians) from controlling expenditure to delivering outcomes. A specific outcome would be the reduction of poverty. However, as indicated above, poverty can only be evaluated through a series of measures, e.g. the UN Human Poverty Index measures, and a range of variables influences each of these measures. Therefore, to implement performance management as a
practical system, outputs must be developed that can act as surrogate measures for outcomes. The linkage is illustrated in Exhibit 6 below.

Exhibit 6: Outcomes and outputs

The conclusion is that there are two surrogate groups of measures for the impact of strategies on outcomes: (1) Input measures - can be achieved by tracking expenditures, dealt with separately below; (2) Output measures - from the analysis above output measures must be linked to both input (expenditure) and outcomes. This paper is not primarily concerned with the development of output targets, but six key requirements are set out below.

1. Output targets must be linked with the budget process so that there is a direct link between expenditure and performance delivery. In Lesotho, an approach has been developed for the health sector where any increased expenditure must be justified in terms of change in anticipated outputs. A set of performance indicators unrelated to the budget process is unlikely to be useful.

2. Outcomes and outputs need to be organised in hierarchy, so that one outcome is represented by a series of outputs. The Logical Framework approach is a useful tool for achieving this relationship.

3. Output targets must be capable of normative measurement of changes in terms of both quality and quantity within a specified period of time. This does not preclude judgement evaluations, but requires that they are made specific.

4. Targets need to be established participatively involving both those who execute policies and potential beneficiaries. In the case of pro-poor strategies this means involving poor people or their representatives. Participatory target setting ensures commitment and also relevance of output targets.

5. A transparent system of expenditure and performance reporting linked to original targets and individual responsibility, and subject to independent audit, review and accountability.

6. Finally, there needs to be rewards for good performance and sanctions for poor performance. A performance management system that is ignored in staff evaluations, or where public servants are not made accountable, is unlikely to be effective. The danger is that managers alter their behaviour to do well exclusively in terms of their performance targets, which may be sub-optimal from the perspective of the nation as a whole.

Expenditure tracking and government accounting systems

It follows from the model in Exhibit 6 above that the first step in managing pro-poor strategies is to ensure that money is actually spent as allocated in the
budget. There is a clear but asymmetric relationship between expenditures and outcomes - expenditure is a necessary but not sufficient condition for achieving a given outcome. There is no known research on the correlation between expenditures and outcomes as compared to that between outputs and outcomes. This area is referred to as expenditure tracking, but in fact embraces a number of issues.

There is evidence that even where funds are allocated in a pro-poor manner in the budget, that intention is not followed through to actual expenditure. Furthermore, few accounting systems are able to track such expenditures and report on them in a meaningful manner. Yet it is clear that if a pro-poor budget is to achieve its objectives, it is essential both that expenditure takes place as intended, and that such expenditure can be followed through. This requires expenditure tracking and publicly available reports that are both reliable and timely. The analysis above has already indicated why this may not be the case. For clarity the issues are put into a framework in Exhibit 7 below, and then addressed separately in the sub-sections that follow.

Exhibit 7: Expenditure tracking issues framework

In considering these, it is useful to see how the IMF evaluation criteria for expenditure tracking in Exhibit 8 below, fit into the above model. This is indicated by the third column, but in relating these two frameworks it must be recognised that the IMF criteria go beyond expenditure tracking to consider in some instances the whole of government financial management.
## Exhibit 8: Crosswalk of IMF criteria to framework for expenditure tracking

<table>
<thead>
<tr>
<th>Budget Management</th>
<th>Benchmark Description</th>
<th>Crosswalk to Exhibit 7 expenditure tracking framework</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Comprehensiveness</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Composition of the budget entity</td>
<td>“Close-fit or better” to GFS definition of general government</td>
<td>Accounting base, funds and standards</td>
</tr>
<tr>
<td>2. Limitations to use of off-budget transactions</td>
<td>Extra (or off) budget expenditure is not substantial</td>
<td></td>
</tr>
<tr>
<td>3. Reliability of budget as guide to outturn</td>
<td>Level and composition of outturn is “quite close” to budget</td>
<td>Ensuring money achieves intended purpose</td>
</tr>
<tr>
<td>4. Data on donor financing</td>
<td>Both capital and current donor funded expenditures included</td>
<td>Accounting base, funds and standards</td>
</tr>
<tr>
<td><strong>Classification</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Classification of budget transactions</td>
<td>Functional and/or program information provided</td>
<td>Classification and chart of accounts</td>
</tr>
<tr>
<td>6. Identification of poverty-reducing expenditure (e.g., a virtual poverty fund)</td>
<td>Identified through use of classification system</td>
<td></td>
</tr>
<tr>
<td><strong>Projection</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Quality of multi-year expenditure projections</td>
<td>Projections are integrated into budget formulation</td>
<td>See above on budget issues</td>
</tr>
<tr>
<td><strong>Internal Control</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Level of payment arrears</td>
<td>Low-level of arrears accumulated</td>
<td>Accounting base, funds and standards</td>
</tr>
<tr>
<td>9. Quality of internal audit</td>
<td>Internal audit function (whether effective or not)</td>
<td>Quality of financial information</td>
</tr>
<tr>
<td>10. Use of tracking surveys</td>
<td>Tracking used on regular basis</td>
<td>Classification and chart of accounts</td>
</tr>
<tr>
<td><strong>Reconciliation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Quality of fiscal/banking data reconciliation</td>
<td>Reconciliation of fiscal and monetary data carried out on routine basis</td>
<td>Quality of financial information</td>
</tr>
<tr>
<td><strong>Reporting</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Timeliness of internal budget reports</td>
<td>Monthly expenditure reports provided within four weeks of end of month</td>
<td>Quality of financial information</td>
</tr>
</tbody>
</table>
The analysis below used the expenditure tracking framework in Exhibit 7, but uses the cross walk to link this back to the IMF criteria.

**Classification and chart of accounts**

Classification issues have already been addressed above. The IMF framework requires a functional and programme structure, which fits with the model of budget classification in Exhibit 4 above, but the latter goes further and looks for disaggregation to the level of cost centres. The budget classification must be followed through into the chart of accounts, which will in addition include asset and liability accounts depending on the accounting base adopted. Linked to the issue of classification is the ability to analyse information in a manner that is able to relate expenditure to outcomes. This means moving away from traditional unit costs absorbing all overheads, and instead developing models based on activity costing. Activity costing is much closer to the economic concept of marginal cost than is the traditional accounting average unit cost. As such, activity based costing provides a better model for tracking expenditures. If there is a sufficiently detailed classification structure, then the need for separate expenditure tracking surveys should be minimised but such surveys are always likely to be required to relate expenditure to detailed poverty related strategies.

**Quality of financial information**

There are a number of facets to quality of financial information:

- Reliable - more than accuracy, information must be reliable for purpose intended
- Timely - information must be available in time to be useful for decisions
- Credible - information must be believed as reliable by users
- Transparent - information must be made available in an appropriate format to users.

Reliability requires accounting systems, processes, trained staff and internal controls so as to ensure transaction data is correctly recorded and classified. Controls should include reconciliations with external sources, especially with bank accounts (lack of up-to-date bank reconciliations is often an indication of weak financial management, frequently exacerbated by multiple bank accounts). Internal controls should include internal audit. Timeliness is a relative concept. Information should be available in time to influence management decisions. For many pro-poor strategies, information will be required in “real-time” during the financial year, so that resources can be properly managed. For post-event monitoring, there is a longer timeframe, but information is still...
required whilst events are fresh in people’s minds, and the protagonists are still in post. Credibility requires external verification through an independent audit. The audit must be perceived to be independent, be of high quality, and report on issues that are relevant to poor people. For example, the fact that money intended for primary health care has been diverted to pay for sophisticated equipment in hospitals in the capital city. Finally, transparency requires that information should be made available to poor people or their representatives quickly, in an appropriate format, and in a manner that makes analysis and interpretation feasible.

**Accounting base, funds and standards**

There can be no doubt that an accrual accounting base provides a more meaningful and logically consistent base for tracking expenditure. It will, for example, identify unpaid bills, other liabilities, and assets and relate expenditures to appropriate accounting periods. However, it is equally certain that most poor countries will not have the resources to adopt full accrual accounting for some time into the future. It is therefore necessary to adopt a cash basis of accounting so that it can provide the required information for tracking pro-poor expenditure. There are a number of approaches. A modified accrual basis can provide information on unpaid bills and better manage intertemporal adjustments. The adoption of International Public Sector Accounting Standards (IPSASs) provides a framework for measuring and presenting accounting information, including the format of published financial statements.

The IMF GFS Manual provides a definition of the government entity. The issue is ensuring that the government budget comprehensively includes all government resource flows, and that these are all reflected through the accounting system. Very often some resource flows (e.g. commodity aid, direct payments for services) are not captured in the budget and hence the budget is an incomplete picture of resources allocated to sectors. Even when captured in the budget, the flows may not be reflected through the accounting system (for example because of the use of trust bank accounts or direct donor disbursements). All resource flows do need to be captured to provide comprehensive expenditure tracking. A fund approach may be used to identify pro-poor expenditure, as has been adopted in Uganda with the Poverty Action Fund, or in Tanzania with the Multilateral Debt Fund. Funds can be a useful device, but they have very definite limitations because (i) funds do not necessarily capture additional spending on poverty reduction; (ii) separate funds do not provide assurance that sufficient funds have been allocated for poverty reduction; and (iii) management of funds diverts resources.

**Ensuring money achieves intended purpose**

The problem of resources not reaching the intended point of service delivery has been repeatedly experienced—especially where decentralisation of services has enabled local Government to access resources. There are various approaches to ensuring money reaches its intended target, for example hypothecation, earmarking, and ring fencing.

Under hypothecation, funds generated from a specific source (e.g. a road cost recovery scheme using tolls) are used in relation to the same activity (e.g. road maintenance). Hypothecation is particularly appropriate for cost recovery funds and often happens informally (e.g. hospital charges being kept by the hospital). Earmarking describes the situation when funds are provided, typically by an external donor, and are earmarked for a particular activity or purpose. The earmarking may be built into the loan or grant conditionality, and can often be
enforced through a staged or tranche release. Ring fencing applies where a budget allocation for a particular purpose, e.g. primary education, is protected against cuts through a notional ring fence. The effectiveness of ring fencing depends on the robustness of the government in ensuring it is observed.

Each of the above approaches is a tool to ensure funds are used for the purpose intended, and are particularly important in protecting social and pro-poor expenditure. However, even if successful the problem of fungability remains. Money is fungible when a government offsets donor spending on a particular purpose by reducing its own expenditure on the same purpose. For example, donor funding earmarked to health will not increase total health spending if government reduces its own health spending, and uses the funds thus released for some other purpose. Fungability means that countries are able to expend money in accordance with government priorities even though aid funds may be provided for some different set of priorities.

If donors disagree with government spending priorities, they can try to influence them through policy dialogue, through conditionality, or by earmarking their aid. Depending on the stage in the budget cycle at which earmarking takes place and government reactions to it, it may be capable of changing allocations between or within sectors, or the extent to which aspects of the finally approved budget are actually executed. It requires strong assumptions regarding the efficiency of the budget process and the relative power of the finance ministry before donor earmarking is rendered entirely impotent.

Conclusions on expenditure tracking

The analysis above indicates that expenditure tracking can become complex, and requires a strong accounting system to be effective. It is fundamental that such a system must be an integral part of the budget/accounting system, not a “bolted on” extra system. Making the poverty expenditure tracking integral to accounting has clear advantages - costs are minimised, the credibility of the data is improved, and sustainability is made feasible.

Changing government financial management to a pro-poor orientation

The analysis above indicates some of the extensive range of actions and possibilities for a pro-poor orientation in financial management. Without such an orientation, many of the strategies will be difficult, if not impossible, to implement successfully. Experience is that it is feasible to implement technical changes in systems, but much harder to implement real changes in behaviour. This appears to reflect general experience: “Improved capacity in budget formulation may be less difficult to achieve in the short term, but it may prove ineffective unless accompanied by reforms in budget execution and reporting that are more difficult to achieve.”

Much technical work, usually with donor support, is being undertaken to establish medium term and/or performance budget systems, to implement so-called “integrated financial management systems” (usually accounting systems). Many of these activities will yield technically sound solutions, and there is no doubt that this will provide an improved information infrastructure. However, in itself this will not result in pro-poor financial management, because the latter requires all of the changes identified above. In summary a pro-poor financial management structure requires the features identified in Exhibit 9 below to be functioning.
### Exhibit 9: Summary of features of pro-poor financial management

<table>
<thead>
<tr>
<th>Major area</th>
<th>Required features</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participation in the budget process</td>
<td>Recognition of organisational complexity of budget processes. Enable effective participation by poor people. Achieve accountability and transparency</td>
</tr>
<tr>
<td>A sector wide approach</td>
<td>Need to adopt a sectoral approach, which may cut across government organisation structures, involve a broad definition of government and may even include non-government organisations, as the framework for resource allocation decisions</td>
</tr>
<tr>
<td>Budget classification</td>
<td>Classification by functions and programmes Preferably a sufficient level of disaggregation to identify cost centres controlled at a decentralised level</td>
</tr>
<tr>
<td>Budget timeframe and MTEF</td>
<td>A medium term expenditure framework (MTEF) integrated with the annual budget process. Legal status of MTEF: Procedures to avoid lapsing of budget allocations for pro-poor expenditure</td>
</tr>
<tr>
<td>Cash management substituting for budget management</td>
<td>Realistic forecasts of resource availability taking accounting of all anticipated outflows, and expenditure plans that recognise committed costs</td>
</tr>
<tr>
<td>Ability to translate budget decisions into actions</td>
<td>Expenditure management processes that efficiently and expeditiously lead to disbursement of funds without excessive transaction costs, and minimise opportunities for corruption</td>
</tr>
<tr>
<td>Performance management</td>
<td>Output targets linked to budget Hierarchy of outcomes and outputs Outputs capable of normative measurement Participation in setting outputs Transparent performance reporting subject to audit</td>
</tr>
<tr>
<td>Expenditure tracking</td>
<td>Classification followed through into chart of accounts and reporting system Quality financial information - reliable, timely, credible and transparent Appropriate accounting base, cost models and use of fund accounting Strategies to ensure money reaches its target</td>
</tr>
</tbody>
</table>
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