Good governance for cost effective financial management

A public sector financial management approach

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ABSTRACT

In their endeavour to achieve sustainable development, developing states face serious challenges in public governance, particularly in general and public finance management. This article focuses on the problems of holding the public service to account for the achievement of objectives, compliance with relevant laws, efficient utilisation of public resources and accurate financial reporting. To ensure that the public service acts in the interests of the public it serves and secures the public interest, a system of governance, including monitoring and evaluation, is required. Governance occurs at various levels from the State to particular public organisations. The paper addresses the accountability of public accounting officers and authorities for their public finance responsibilities on the basis of performance (including finance) reports in the State and public governance contexts.

The article aims to examine appropriateness of public finance management in the State and public governance contexts. The article’s objectives are, firstly, to establish the nature of public sector finance in the context of State governance, secondly, to determine the requirements for public finance management in public organisations in the context of public governance and, thirdly, to address aspects such as the financial responsibilities, accountability, monitoring and reporting relevant to public organisations’ governing bodies.

INTRODUCTION

Public sector finance is a key component of political, economic and administrative governance. Sound public finance management requires the transparency of public activities and their financing, as well as the accountability of the persons responsible for public finance
management. An essential component of public finance management is thus a system of monitoring and reporting to ensure that public officials can be held accountable for their actions (or inaction), and that laws are administered and public services are delivered efficiently accordingly.

Developing states that want to achieve sustainable development face many serious challenges in public governance in general, and in public finance management in particular. This article focuses on developing states and how they can hold the public service to account for the achievement of objectives, compliance with relevant laws, efficient utilisation of public resources and accurate financial reporting. To ensure that the public service acts in the interest of the public it serves, a system of governance is required to secure the public interest, and such a system must include monitoring and control. Governance occurs at various levels, from the State to particular public organisations.

The general development of a country depends heavily on the efficient allocation and use of the resources available to the government for the regulation of society and the effective delivery of public services, according to the needs of the society the government serves. Weak state and public governance allows corruption to divert public resources from the purposes for which they were allocated. Conversely, good public governance resulting in good public finance management can prevent such losses.

Public finance is at the core of good public governance, and both elements are essential for sustainable development. The general approach followed in the article is to look at public finance in the context of public governance. The focus is on the public finance responsibilities of the governing boards of public organisations in a public (corporate) governance context, as well as on the monitoring and reporting modalities designed to enable accountability.

**PUBLIC SECTOR FINANCE**

Government is at the core of the public sector and consists of all public executive authorities and their instrumentalities. The combination of all government units constitutes the general government, which consists of the national (central) government, local government and sub-national government levels, each with its own budget, covering its designated sphere of responsibility and activity.

Public sector finance encompasses government’s capacity to raise revenues, set spending priorities, allocate resources and effectively manage the delivery of those resources. Financial management techniques assist government to translate its strategies into action, provide financial information for decision-making and accountability, and provide a responsive, efficient public sector. The broad objectives of public finance are to achieve overall fiscal discipline, allocate resources to priority needs, and deliver efficient and effective public services (World Bank 1998:17). Sound public finance management supports aggregate control, prioritisation, accountability and efficiency in the management of public resources and delivery of services, all of which are critical to achieving public policy objectives. Effective public financial management is therefore central to government’s ability to deliver services to citizens and ensure sustainable development.

Revenue administration is an integral part of overall financial administration. Taxation is its most important means to marshal financial resources by collecting financial resources
from taxpayers. The government can then use these resources to execute the basic functions of the State, namely maintain law and order, defend the country, engage in foreign affairs and provide public services. Any excess over current expenditure may be spent on capital projects or other aspects of socioeconomic development. Part of government’s financial resources may also be used for projects to be implemented by the private sector to ensure the optimum balance between the public and private sectors (Shende 2000:14).

Tax laws may fail to achieve their purposes in practice, unless they are efficiently implemented and taxpayers can be induced to comply with these laws voluntarily (or, if necessary, can be compelled to do so). Efficient and effective tax administration is therefore a pre-requisite for a tax system to fulfil its revenue-producing potential. But even the best designed system is only as good as the administration which implements it. Since revenue collection is the core function of revenue administration, it is vital to harness the administration’s human, material and financial resources in an efficient and coordinated manner to collect the optimum financial resources at the minimum cost (Shende 2000:14).

Public expenditure administration constitutes the biggest part of the overall financial administration. Expenditure administration employs financial resources from public revenue to perform government functions and deliver public services, using an effective financial management system to implement policies to promote national socio-economic development goals. Public financial management constitutes all or part of the processes and functions of planning, programming and budgeting, budget execution and accounting, auditing and evaluation. All these activities are aimed at ensuring that government’s financial resources are used in accordance with the legal prescripts, as efficiently, effectively and rationally as possible to yield optimum results, with transparency and accountability to the legislature and the population at large (Shende 2000:39).

Developing countries have to maximise the mobilisation of financial resources from both domestic and foreign sources and, at the same time, ensure that those resources are used in the most efficient and productive way to benefit all classes of the population, including the poor. They must also ensure that public financial operations are reliably accounted for to inspire confidence in both their citizens and foreign donors and investors.

CONTEXTUALISATION OF PUBLIC GOVERNANCE

For the purposes of this article governance is defined by the UN Development Programme (UNDP) as

*the exercise of economic, political and administrative authority to manage a country’s affairs at all levels. Therefore public governance comprises mechanisms, processes and institutions, through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations and mediate their differences (UNDP 1997(a):5).*

Both the UNDP and the World Bank have identified core characteristics of good governance and their relation to sustainable development. These characteristics vary according to their respective approach and goals. Good governance requires efficient institutions. A predictable economic and political environment is also necessary for economic growth and
for the effective functioning of public services. Good governance ensures that political, social and economic priorities are based on broad consensus in society and that the poor and vulnerable participate in decision-making regarding the allocation of development resources. Both the UNDP and the World Bank stress that the elements of good governance relevant to public sector management are the rule of law, transparency, responsiveness, effectiveness and efficiency, as well as accountability (Abellatif 2003:4–5).

The UNDP (1997(b):9) lists three important domains of governance. Firstly, the State must create a political environment conducive to sustainable development, by focusing on issues such as

- clarifying government’s role in the social integration context, the economy and protection of the environment;
- protecting the vulnerable in the population;
- creating political commitment to economic, social and political restructuring;
- providing infrastructure;
- decentralising and democratising government; and
- strengthening the financial and administrative capacities of local, urban and metropolitan government.

Secondly, the private sector and the market clearly have crucial roles to play in sustainable development, which requires the creation of livelihoods and provision of sufficient income through productive employment so that people can improve their living conditions. However, the ability of the private sector, including the informal sector, to create jobs and expand employment depends on market development. Market development, in turn, depends on expanding and strengthening the private sector by providing incentives and support for privatising State-owned enterprises, developing small- and medium-sized enterprises, and, in some circumstances, attracting, developing and expanding transnational corporations.

Thirdly, civil society organisations facilitate political and social interaction to mobilise various groups in society to participate in economic, social and political activities. Civil society provides important checks and balances on government power and on the private sector, but can also contribute to, and strengthen, both the public and the private sector domains (UNDP 1997(b):15–18).

Good public sector governance fulfils an important role by being adequately accountable to its many stakeholders and encouraging performance improvement while satisfying control and compliance requirements (IFAC: 2001; ANAO: 2003; CIPFA: 2004). Public sector governance of a country manifests at the national, sub-national (if applicable) and local spheres of government, as well as in the legislative, executive, judicial branches, each supported by an administrative component. The myriad of public organisations functioning collectively in this governance arrangement each serve an individual purpose employing public resources to achieve their mandated objectives.

**Corporate and public governance**

Corporate governance is a specialised use of governance, and refers to the system by which organisations are “directed, controlled and held to account” (Cadbury Committee 1992:15).
It is underpinned by principles of openness, integrity and accountability. The Cadbury Committee (1992) found that

…the governance role is not concerned with running the business of the company, per se, but with giving overall direction to the enterprise, with overseeing and controlling the executive actions of management and with satisfying legitimate expectations for accountability and regulation by the interests beyond the corporate boundaries …. All companies need governing as well as managing.

This finding applied specifically to private sector business organisations (and implied the relationship between a company and its board of directors), but this construct has subsequently been adopted for application to public organisations in the public sector by specialist organisations such as the International Federation of Accountants (IFAC), the Institute for Public Finance Accounting (IPFA), the Australian National Audit Office (ANAO), the United Kingdom Audit Commission and the Ministry of Finance (MOF) in the Netherlands. The application of the construct is intended to support those responsible for such organisations in governing their respective organisations better.

The equivalent in the public sector to a board of directors governing a private sector company is the Minister, as the executing authority that directs and controls a public sector department (or exercises ownership control of a public entity through a board), and the accountability of the governing body (consisting of the subordinate chief executive – the Accounting Officer – with top managers) of the public organisation for the execution of the programme budget (or compact), both in performance and financial terms. Both the Minister and the governing body are subject to oversight by the Legislature – the Minister in respect of policy and outcomes and the governing body in respect of programme/compact implementation and related outputs.

This article focuses on the public finance responsibility and accountability of the governing body at the nexus of the political-administrative interface. The focus of public governance is the governing body of a public organisation or, in public finance terms, the accounting officer or accounting authority. The term governing body is used in this paper to denote the top management group.

Public governance arrangements

Developing countries’ institutional arrangements differ, according to the local political system, but the broad concepts and principles of public governance remain generally valid:

● The overall public governance framework is normally set by the Legislature, which represents the citizens through legislation.
● The Executive as executing authority usually ensures that the governance framework is applied to public organisations in their jurisdiction.
● Governing bodies are responsible for governing their respective public organisations accordingly.
● The Legislature authorises the mobilisation and application of financial resources by the Executive and exercises oversight over the Executive and Administration. The
Legislature is usually responsible for approving the public budget and authorising its execution.

- The Executive must normally execute the budget with the support of the Administration. Budget execution involves expending funds for resources used in administering related programmes.
- Financial management and accountability are usually the responsibility of the Accounting Officer, as determined in the budget system law and/or budget law. The Accounting Officer in the governing body implements the budget under the direction and control of the Executive with due diligence in respect of economy and efficiency, compliance with applicable laws as well as applying appropriate accounting methods and reporting standards.
- The Executive is usually responsible for reports to the Legislature to account for the Administration in their jurisdiction.

The Legislature holds the Executive and its Administration accountable for financial management, the use of resources entrusted to them and the results achieved, thereby playing a cardinal role in public governance framework. The Legislature usually reviews the annual reports of the executive institutions (including the financial reports of the Accounting Officer), evaluates the standard of their work and makes recommendations, based on the facts contained in the related regularity and performance audit reports by the legislative auditor. Reporting, auditing and scrutiny must be expeditious, so that timely interventions in the execution of the pursuant cycle(s) are possible. The legislative auditor performs a follow-up of the adverse audit findings to review the implementation of the recommendations of the Legislature by the Executive and Accounting Officer or Authority.

Financial accounting and reporting should be based on generally accepted public accounting standards and should be audited by professional legislative auditors to enhance the quality of information used for financial accountability purposes. Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in the financial statements. Compliance with accounting standards is normally necessary for financial statements to give a fair reflection of the financial state of a public organisation (IFAC 2001:6–7).

**STRATEGIC ENABLERS TOWARDS GOOD GOVERNANCE**

The governing body of a public organisation must design specific enablers to institutionalise effective governance, as follows:

- Specific standards of behaviour are required – thus, a formal code of conduct is designed and adopted to clarify specified standards of behaviour. All members of the entity, including the governing body, must subscribe to this code. Organisational mechanisms are established to ensure that all members act honestly, objectively and with integrity in organisational matters and are not influenced by prejudice or partiality, and that there is no conflict of interest (CIPFA 2004:13).
- Organisational structures and processes are critical where a public organisation must be headed by a governing body to lead and control the entity and monitor
the executive management. In this case, the roles, responsibilities and authorities of the head of the governing body should be divided and balanced (CIPFA 2004:9–10; MOF 2000:17). A clear framework of delegations or powers, which includes a formal schedule of those matters specifically reserved for the collective decision of the governing body, should be established and maintained to ensure firm direction and control of the entity. The governing body must be served by clearly documented and understood management processes for policy development, as well as formal procedural and financial regulations to govern the conduct of the governing body’s operations. Relevant information, advice and resources should be at the disposal of the governing body to enable the members to perform their respective roles effectively (CIPFA 2004:16; MOF 2000:17).

- Clear communication channels and procedures should be established to communicate with stakeholders on the entity’s mission, roles, objectives and performance. These communications must be based on a commitment to transparency and accuracy in all the entity’s activities, except when specific circumstances justify confidentiality (CIPFA 2004:23).

- Control is a strategic enabler. It implies a framework of integrated components of risk management, internal control and internal audit (CIPFA 2004:16; INTOSAI 2004:6). The internal audit function should be under the control of an independent audit committee consisting of non-executive members. Their purpose is to review the framework of control and the external audit process. Governing bodies should oversee budgeting and financial management and ensure that procedures are in place to make these processes effective and efficient.

- External reporting implies publishing a regular and timely annual report (including financial statements) presenting an objective, balanced and understandable account of an entity’s activities and achievements and its financial position and performance (CIPFA 2004:24; MOF 2000:18). The minimum that must be contained in such a report as required for the control function to ensure effective governance is the following:
  - a declaration of responsibility for implementing the budget and providing authorisation for the acquisition (if applicable) and use of financial resources;
  - the financial statements that present the state of affairs of the entity fairly at the end of the financial year, and the results of the operations for that year;
  - maintenance of an effective framework of control;
  - assurance of consistent use of appropriate accounting policies, supported by reasonable and prudent judgments and estimates; and
  - assurance of adherence to applicable accounting standards.

In their annual reports, governing bodies must include a statement on whether they have adopted standards or codes of governance. This statement should identify the standards or codes adopted, as well as confirm compliance with them (or clarification on non-compliance and reasons for it). The financial statements contained in the annual report should be prepared in accordance with prescribed accounting standards and applicable legislation. Relevant performance measures to ensure and demonstrate that all resources have been procured economically and are utilised efficiently and effectively must be established and reported (IFAC 2001:15–19).
The finance responsibilities of governing body are normally set out in one of the country’s budget system laws. The relationships between these finance responsibilities and the various functional aspects of public financial management are explained in regulations relating to the budget law and may be further amplified in practice notes. The general finance responsibilities of governing bodies are to:

- promote orderly, economical, efficient and effective operations, and produce quality products and services consistent with the organisation’s mission;
- safeguard resources against loss due to waste, abuse, mismanagement, errors and fraud;
- promote adherence to laws, regulations, contracts and management directives; and
- develop and maintain reliable financial and management data, and accurately present that data in timely reports.

These finance responsibilities are aligned as the purposes of the system of internal control that the governing body is responsible for establishing and maintaining, as well as forming the basis for external accountability.

In South Africa, the general finance responsibilities of accounting officers, according to the Public Finance Management Act, 1999, are normally categorised into sections addressing the following areas:

- general responsibilities;
- budget control responsibilities;
- reporting responsibilities;
- transfer of assets and liabilities;
- exercise of virement; and
- assignment of powers and duties.

The Public Finance Management Act, 1999 is a world-class public financial act currently used as a benchmark and is therefore the focal reference for this section of the paper. General duties include the central obligation to have and maintain systems of financial, risk and internal control management, including conducting internal audits under the control of an audit committee. Other system obligations relate to capital projects assessment, asset management and procurement. Revenue must be collected and expenditure controlled to prevent improper transactions. Disciplinary steps must be taken against subordinates for contravention of the Act, improper expenditure and undermining internal controls; such events must also be reported to higher authorities. Policy decisions must be preceded by consideration of the financial implications of the decisions and assurances must be obtained prior to the transfer of funds to external entities.

With reference to budget control, accounting officers who implement budgets must stay within the authorised budget and report any unauthorised expenditure to higher authorities. Budget execution flexibility is provided through the virement, but if this power is exercised, it must be reported expeditiously. Reporting obligations consist of preparing an annual report of actual performance against pre-set objectives with audited financial statements for submission to the relevant minister. Cash-flow plans must be submitted prior to the
start of every financial year and periodic actual cash-flow reports must be provided. Any financial information required by the Treasury and Auditor-General (or equivalent) must be provided, and the proper transfer of assets and liabilities must be ensured when functions are transferred between public entities. Accounting Officers and Authorities may assign their financial management powers and duties to subordinates but remain accountable.

PUBLIC GOVERNANCE – MECHANISMS TO ENSURE FINANCE ACCOUNTABILITY

Public organisations are required to be accountable for their activities. Public managers must be able to account for funds spent on a programme, and also to demonstrate the value of the programme and its accomplishments. Therefore accountability is defined as “a relationship based on the obligation to demonstrate and take responsibility for performance in the light of agreed expectations” (Treasury Board of Canada 1998:3).

Accountability requires a relationship of conferring responsibility and reporting back on the expected and agreed performance and on the manner in which the responsibility was fulfilled. The agreement regarding expected performance between superiors and subordinates can be explicit or implicit. A robust framework of accountability thus moves away from the traditional outlook of blameworthiness or “catching a thief” toward reporting on results achieved, compared to the expectations agreed upon in advance, highlighting practical constraints and willingness to improve in the light of experience.

The principles of accountability consistent with the abovementioned definition embody the practices associated with a results-oriented environment, defining a relationship and practice termed “effective accountability” (Treasury Board of Canada 1998:3). Thus the following are needed:

- clearly defined roles;
- clear performance expectations;
- balanced expectations and capacities;
- credible reporting; and
- reasonable review and adjustment.

A results-oriented environment requires shifting the subject of accountability from outputs to outcomes. In most developing countries, performance management systems still tend to focus on input economy and output effectiveness, because accounting systems are still cash-based, and are thus unable to report output efficiencies. The advantages of accrual accounting and outcomes-based performance management are currently beyond the reach of many developing countries, which are still wrestling with the problems of getting the basics in place. However, some aspects of these principles are useful to guide accountability relationships.

Ensuring effective finance accountability involves the review of an organisation’s activities and transactions to assess the quality of performance over time and to determine whether controls are effective. Management should focus monitoring efforts on internal control and on achieving the organisation’s mission. For monitoring to be most effective, all employees need to understand the organisation’s mission, objectives, risk tolerance levels and their own responsibilities.
Internal control

There are many published standards and guidelines on internal control, each defining it in various ways, but it is generally agreed that internal control is extensive in scope, is related to an organisation’s mission, and depends on people in the organisation. Internal control is focused on achieving the organisation’s mission. Therefore, it is essential that an organisation has a clearly stated mission that everyone in the organisation knows and understands. It is also important to grasp that, although good internal control provides reasonable assurance that goals and objectives are met, it cannot guarantee organisational success. Nevertheless, goals and objectives are much less likely to be met if internal control is poor. The fundamental principles of internal control are rooted in well-established organisational techniques and practices.

Risk management

Risk should be assessed and managed through an organisation-wide effort to identify, evaluate and monitor any events that threaten the accomplishment of the organisation’s mission (INTOSAI, 2004:22). For each risk identified, management should decide whether to accept the risk, reduce it to an acceptable level, or avoid it. Once all the operational and control objectives have been noted, managers must identify all the risks associated with each objective (threats, errors, fraud, system breakdowns) and external risks (for example, changes in legislation, their impact and likelihood).

To prevent risk or reduce it to an acceptable level, management should use risk assessment information to help identify the most effective and efficient control activities available for handling the risk. Management should maintain its analysis and develop a rationale that supports its risk management decisions. Management should review these decisions periodically to determine whether changes in conditions warrant a different approach to managing, preventing and reducing risk.

Control activities

Control activities are tools (manual and automated) that help identify, prevent or reduce risks that can impede accomplishment of the organisation’s objectives (INTOSAI 2004:28). Management should establish control activities that are effective and efficient (provide the maximum benefit at the lowest possible cost) by predicting potential problems before they occur, and implementing ways to avoid them. Detection activities are designed to identify undesirable events that do occur, and to alert management about them to enable management to take corrective action promptly. However, excessive use of prevention controls can impede productivity. Many different control activities can be used to counter the risks that threaten an organisation’s success.

Safeguarding assets

Safeguarding assets involves restricting access to resources and information to help reduce the risk of unauthorised use or loss. Management should protect the organisation’s
equipment, information, documents and other resources that could be wrongfully used, damaged or stolen. Supervision refers to on-going oversight, management and guidance of an activity by designated employees to help ensure that the results of the activity achieve the set objectives. Separation of duties is the division of key tasks and responsibilities among various employees and sub-units of an organisation. By separating key tasks and responsibilities – such as receiving, recording, depositing, securing and reconciling assets – management can reduce the risk of error, waste, or wrongful acts.

**Monitoring**

Internal control systems should be monitored to assess the quality of the system’s performance over time to ensure that controls are operating as intended and that they are modified appropriately for changes in conditions. Monitoring is accomplished through routine activities, separate evaluations or a combination of these (INTOSAI 2004:40). On-going monitoring of internal control is built into the normal, recurring operating activities of an entity. Such activities cover each of the internal control components and involve action against irregular, unethical, uneconomical, inefficient and ineffective internal control systems. The scope and frequency of separate evaluations depends primarily on the assessment of risks and the effectiveness of on-going monitoring procedures. Specific separate evaluations cover the evaluation of the effectiveness of the internal control system and ensure that internal control achieves the desired results based on predefined methods and procedures. Internal control deficiencies should be reported to the appropriate level of management and monitoring should ensure that audit findings and recommendations are adequately and promptly resolved.

**Annual reporting**

Public organisations are required to publish and distribute to the public an annual report within a reasonable period after the end of the financial year (IFAC 2001:18). This is to account for the use of public resources placed at their disposal to achieve approved objectives. The report must be finalised within prescribed time limits (normally six months) to facilitate timely corrective measures in pursuant financial cycles. The report should present a balanced and objective account of the entity’s activities, achievements and of its financial performance and position at year-end. The annual report should state the mission, goals and measurable objectives including performance measures against which actual performance is reported. The audited financial statements, audit committee report as well as the external auditor’s report should be included. The board members’ names and remuneration should be disclosed in the case of corporate public entities.

A management report should accompany the report commenting on the financial and non-financial performance of the entity and reflect on the ability to meet future liabilities and commitments. The management report should include a statement

- indicating management’s responsibility for providing authorisation for the acquisition and use of financial resources in the implementation of the budget;
- stating that the financial statements fairly present the state of affairs of the entity at the end of the financial year and the results of the operations for that year;
• showing that an effective framework of control has been maintained;
• providing assurance that accounting policies were consistently applied and supported by prudent judgements; and
• that applicable accounting standards have been adhered to (IFAC 2001:18).

The report should also include a statement on whether a code of governance has been adopted and if so, identify the specific code and certify compliance with it. If aspects have not been complied with, these aspects should be mentioned, with supporting reasons. The status of the entity as a going concern and if applicable, its dependence on subsidies or financial support should also be reported on. Any uncertainty should be declared together with the reason(s) and explained.

Financial reporting

Governing bodies should ensure that the financial statements contained in the annual report are prepared in accordance with prescribed accounting standards and applicable legislation (IFAC 2001:52). Accounting standards are a prerequisite to financial accountability, because compliance with these standards promotes the reliability, consistency and transparency of financial information. Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in the financial statements. Accordingly, compliance with accounting standards is normally necessary for financial statements to give a fair presentation. In cases where prescribed accounting standards conflict with legislation, the legislation prevails, but if the conflict is material, it should be declared as an aspect of non-compliance. The financial statements should be adopted and approved by the Accounting Officer or Authority, who is the steward of the allocated public resources (IFAC 2001:53)

CONCLUSION

There is widespread awareness that a lack of good governance, transparency and accountability in government operations impedes progress towards sustainable development. Weak State and public governance allow corruption to divert public resources from the purposes for which they were allocated. Good public finance management provided through good public governance can prevent or reduce such impropriety. Governing bodies should thus take cognizance of the principles of public governance and take the suggested steps to improve their governance of the public organisations for which they are responsible. Governing bodies should furthermore take care to understand their individual and collective public finance responsibilities and be prepared to give an account of their activities, not with apprehension, but with a sense of pride in the performance of the organisations under their control. To this end, governing bodies should implement and monitor powerful systems of internal control and report their organisations’ financial performance and position comprehensively and with confidence.
REFERENCES


