Public Sector Financial Management for Managers

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**Key Points**

The Public sector is responsible for bringing together large amounts of resources to achieve a range of public goods. This responsibility comes with considerable complexity and expectation.

While the term resources embraces many elements, people, time, attention, focus, and capacity, in the end, each of these involve money.

Financial Management is an important tool that helps the Public sector take care of money in a systematic, efficient, transparent, and legitimate way. Public sector Financial Management has **3 Cornerstones**:

- Resource Allocation (Getting Money),
- Controlled Delivery (Spending Money), and
- Accountability (Reporting on Money).

These 3 Cornerstones of Public sector Financial Management can be broken down into various parts, which will be explored in detailed throughout this guide. We can begin to
identify some of the components of these three broad stages by asking the questions: What is the Public sector, and what is Financial Management?

**Question 1: What is the Public sector?**

**Summary:** The Public sector needs to work within specific financial boundaries while trying to solve problems affecting the citizens it represents and serves.

**5 Key Features**¹:

i) **The Public sector is broad.** It encompasses all organizations that receive their funding from public sources such as taxes, fees or licences. Therefore, it will embrace not just government departments, but also government enterprises.

ii) **The Public sector has multiple goals.** Rather than having a single bottom-line, the public sector has several, which are being pursued at once.

iii) **The Public sector uses various tools to reach it goals.** There are a series of instruments used to achieve the goals of government².

iv) **The Public sector often uses the Private Sector to deliver Public Goods.** Modern governments frequently use contracts with private corporations as a means of acquiring needed expertise, outsourcing work, or extending their workforces while seeming to contain the growth of the public service.

This contracted work does not mean that the regular public service is relieved of its accountability for public funds. Governments devote considerable energy to administering contracts, especially during a period of increased scrutiny by the public and by the contracting community in particular.

v) **The Public sector is a democratic institution.** Governments own none of the resources they spend. Taxpayers do. In a democratic society, the ways in which governments spend resources must be transparent and readily open to questioning.

Accounting for Public sector funds and their proper expenditure is not only part of good management, it is essential to good government and good governance of the public enterprise. It is also where governments are most heavily scrutinized and where they can get into a great deal of trouble. Such scrutiny is one of the basis of a government’s legitimacy.

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¹ CICA Public sector Accounting Handbook, Revised Update No. 18, Section PS 1100, Appendix A
Question 2: What is Financial Management?

Summary: Financial Management helps to provide key information to decision-makers and introduces controls that either prevent abuse or create incentives for good service to the public. Financial Management helps the Public sector collect money, allocate money, spend money, weigh the costs and benefits of certain programs, account for money, report on how money was spent, and plan for the long-term.

8 Key Features:

i) Financial Management involves the collection of money. The Public sector makes most of its money through taxation, transfers, fees, the sale of goods.

ii) Financial Management involves allocating resources. The income of the Public sector is not tied to any one specific goal. Rather, Public sector funds are consolidated into a Consolidated Revenue Fund (CRF) and subjected to a democratic decision-making process that distributes them across a range of activities. This is known as the budgetary process. There are exceptions to this rule in which specific taxes or fees are directed to specific programs.

A Budget tells the public how the government intends to spend its money. The budgetary process is a planning tool and a tool of regulation and control. A government budget sets a legal limit for expenditures. It also creates the legal authorization for delegated officials to spend fund.

A Budget is also the tool by which the government’s financial performance is judged. Managers are held to account for their performance relative to the budget.

iii) Financial Management involves spending money. Delegated officials are expected to spend public funds for the purposes for which they were allocated. Therefore, financial management involves having controls in place to monitor expenditures.

iv) Financial Management involves oversight—watching the money. The government must frequently and systematically monitor and report on the flow of money. This ensures actual financial activity matches planned financial activity. Financial roles and responsibilities as well as financial reporting timelines, are outlined in law to ensure specific individuals are linked to the success or failure of a particular stage in the financial process. Information systems support these roles by making public servants aware of their level of progress.

Legislation creating public organizations can be very broad with respect to the amount of legislative control that is exerted as the organization goes about its day-to-day business. Legislatures seldom engage in the actual management of public organizations. Rather, they serve other key roles: creating the organization, setting out the policies that they will carry out, providing the funding to carry out the policies, holding the
organization to account either directly or through external auditors appointed by and responsible to the legislatures.

v) Financial Management involves accounting for money collected and money spent. The Public sector must assure the public that its money is being spent well. This means they need to ask:

- Is money being spent for an appropriate use – for the public good?
- Are funds being allocated for the stated purpose?
- Are funds being spent according to the rules that apply?
- Did the funds achieve the intended results?
- Can the funds be traced and identified?
- Can others assess the financial information of the organization—external review or audit?

Essentially, past financial behavior must be reconciled, audited, and reviewed in relation to the budget to give the legislature and public the assurances that funds were spent for their intended purpose. The public accounts and the associated financial statements are the main documents used by government to show financial activity.

vi) Financial Management involves taking care of assets. Public sector organizations build or acquire capital assets. They own capital assets, which can be considerable, in order to deliver services and the public good objectives that they want to achieve. Consequently, the Public sector has considerable maintenance requirements and operational costs. Financial managers must ensure that assets are properly purchased and sustainable.

vii) Financial Management does require due regard for process, record-keeping and reporting. There can be a tension between the objectives of the public service to quickly serve the needs of citizens and effective financial management, seeing it as inhibiting effective client service through excessive controls, inadequate funding or a preoccupation with paperwork. Nonetheless, these requirements remain essential for proper control and accountability as well as public confidence in the government’s financial prudence and honesty.

viii) Financial Management is Everybody’s Business: Often public servants do not see themselves as managers of resources, but rather as policy managers of highly specialized functions. Because of the complexity of the Public sector, the finance function will have its own senior managers who are often separate from line or operating managers. Tensions often ensue between these two cultures. These are normal and, when well managed, healthy and necessary.

In reality, all managers are financial managers. The abilities to obtain resources to achieve program objectives (budgeting), maximize program benefits within the budget (allocation), effectively manage the budget to achieve full benefit (cash management), and demonstrate results and process adherence (accountability), are important management skills for all government employees.
Key Points

- A budget is a time limited plan that puts resources in place to implement the goals of an organization.
- For the public sector, a budget is a legally authorized annual monetized plan that establishes spending limits for the various programs that come out of legislation, policy, and organizational intent. A budget, therefore, does two things:
  1) It translates policy intention into specific activities through resource allocation.
  2) It is also the basis for financial control within the public sector organization in that it articulates expectations of revenue and expenditures. As such, it is a useful benchmark to control the operations of government departments and agencies.

- Typically, a Government will have an organization-wide budget.

  This document will then get divided into parts in order to form department budgets. And then those department budgets will be further divided in order to produce branch budgets of various sorts.

In this section, we will explore the various types of budgets used in the public sector.

The Budget Cycle

There are three budgets in play at all times for public sector managers: past, present and future.

The manager has an immediate concern for the management of funds within the current fiscal year. This is the realm of the use and control of funds, cash management, and program management.

However, the manager also has to continuously participate as part of the planning process to secure funds for coming years. This is the expenditure planning process, the policy planning cycle or the strategic exercises of the organization. This is for development of the future budget.

Finally, the manager must account for past use of funds. This is based on the past budget and the way it was spent.
Importantly, this third budget life - the past - is critical since so much of the budgeting process is *incremental* in nature, as changes are made in small increments based on prior years levels of resources, e.g. an increase of 2% per annum with no change in program fund distribution. Many organizations make the majority of their budget decisions based on past performance and allotments. How much was actually used in the past is an important factor.

**Budget Methodologies**

**Core Elements:** There are three core elements to a budget: revenue, operations and capital. These are described briefly.

**Revenue Budgets:** For the most part, governments manage their revenue strategies at the whole of government level, imposing taxes and fees. They then distribute money to departments through the budgetary and appropriations process. Individual managers have little to do with this part of the budget process, unless they work on the revenue side of government.

**Operating Budgets:** Operating budgets describe the programs and resources used to carry them out within a specified period of time. The operating budget contains the plan for revenues and expenditures for the period, usually referred to as a fiscal year.

In governmental terms, the expenditure plan represents the authorized limit of expenditures for the operating unit. Most operating budget provide funds for such elements as staff, benefits, supplies and operating expenses as well as grants and disbursements.

**Capital Budgets:** Capital budgets contain the plans and resource allocations for capital acquisitions. They receive different treatment than operating funds because their use is often a more complex and longer-term proposition than the one-year operating funds. They often involve complex planning processes with considerable financial risk and cash outlay.

Land and buildings are well-known capital goods. Increasingly, information technology infrastructure is a part of the capital budgets. Determining what is and what is not treated as a capital item is a matter of policy within public sector organizations.

**Organizing Budget Information**

Budgets vary considerably in complexity. This will depend upon the purpose for which they were created and how they will be used. In seeking the best way to display budget
information, there are three main approaches, each with useful intent as well as limitations:

- Line item budgets,
- Program budgets,
- Functional budgets which combine the former two, and
- Performance budgeting.

Most government practice all three forms, using them to meet the various goals of a budget. For instance, a simple line-item budget, described below, will meet the needs of a manager to understand what resources she has and for what kind of purpose, e.g., staff, supplies, etc. A program budget will link such information to the programs within a particular unit. A functional budget, a very common tool, combines the line and program budget. A performance budget will link the money allocated to specific anticipated performance outcomes, e.g., paving so many kilometers of roads for so much money. Each is useful in its own turn.

**Line-Item Budgets:** The line-item budget is one of the easiest to prepare and one of the most useful in terms of control of budgets within a spending period.

The financial information is organized according to the types of expenses or cost categories. These generally focus on staff, supplies, rentals, and contracts, all of which can be characterized as costs of operations.

A simple line-item budget for the Ottawa General Hospital, focusing on expenses only, is shown here.

**Line-Item Budget of the Ottawa General Hospital for Fiscal Year 2005**

<table>
<thead>
<tr>
<th>Object</th>
<th>Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>100. Salaries</td>
<td>$8,000,000</td>
</tr>
<tr>
<td>200. Supplies</td>
<td>2,000,000</td>
</tr>
<tr>
<td>300. Rentals</td>
<td>250,000</td>
</tr>
<tr>
<td>400. Professional Fees</td>
<td>750,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$11,000,000</strong></td>
</tr>
</tbody>
</table>

The main orientation of a line-item budget is expenditure control and accountability. This budget will inform the manager or stakeholders what is being spent on what item of expenditure. These are known as inputs in that they identify the categories of resources, e.g. staff or supplies, needed to do the work. Since it uses common objects or objects codes, it also permits inter-budget cost comparisons between programs or
organizations with similar functions. A good example, if all hospitals used the same object codes or line items, is that it would enable an interested observer to determine if the Ottawa Hospital had a higher staff cost to overall budget ratio than another similar hospital.

**Program Budgets:** Program budgets are budgets which are organized for display purposes according to program types. It shows how resources are allocated to each particular program. This type of budget assigns resources to the operating unit, zone, area or specialized program within which it is being spent.

**Program Budget of the Ottawa General Hospital for Fiscal Year 2005**

<table>
<thead>
<tr>
<th>Unit</th>
<th>Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Operating Room</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>2. Laboratory</td>
<td>1,000,000</td>
</tr>
<tr>
<td>3. Radiology</td>
<td>1,000,000</td>
</tr>
<tr>
<td>4. Patient Care</td>
<td>2,500,000</td>
</tr>
<tr>
<td>5. Outpatient Care</td>
<td>1,500,000</td>
</tr>
<tr>
<td>6. Administration</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>$11,000,000</td>
</tr>
</tbody>
</table>

**Functional Budgets:** A functional budget is a budget that combines the line-item budget with the unit budget to provide a more complete picture of the resource distribution within an organization.

This is often the format that is used for external reporting information. It has the benefit of allowing a better basis for comparison among units. For instance, one area may have high salary costs, e.g. operating room while another, e.g., administration, may be lower. That may reflect the labour intensity of the work or the size of the unit as well as the cost of the professional and support staff in each unit.

The functional budget delivers a better understanding of what funds are to be spent for. It combines information about inputs and units or programs that are being funded. Below is a display of the functional budget of Ottawa General Hospital.
**Functional Budget of the Ottawa General Hospital for Fiscal Year 2005**

<table>
<thead>
<tr>
<th>Unit</th>
<th>100. Salaries</th>
<th>200. Supplies</th>
<th>300. Rentals</th>
<th>400. Professional Fees</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Operating Room</td>
<td>3,250,000</td>
<td>250,000</td>
<td>50,000</td>
<td>450,000</td>
<td>4,000,000</td>
</tr>
<tr>
<td>2. Laboratory</td>
<td>550,000</td>
<td>350,000</td>
<td>25,000</td>
<td>75,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>3. Radiology</td>
<td>450,000</td>
<td>450,000</td>
<td>0</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>4. Patient Care</td>
<td>2,000,000</td>
<td>400,000</td>
<td>0</td>
<td>100,000</td>
<td>2,500,000</td>
</tr>
<tr>
<td>5. Outpatient Care</td>
<td>1,200,000</td>
<td>175,000</td>
<td>25,000</td>
<td>100,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td>6. Administration</td>
<td>475,000</td>
<td>325,000</td>
<td>50,000</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>7,925,000</td>
<td>2,000,000</td>
<td>150,000</td>
<td>925,000</td>
<td>11,000,000</td>
</tr>
</tbody>
</table>

**Performance Budgets**: Performance budgets are intended to link resources to the results desired from a program. While a line-item budget is focused entirely on inputs and a zero-based budget goes back to basics and reinvents itself each year, the performance budget has certain features that move it more into the realm of public sector accountability with a greater emphasis on outcomes and results:

1. there is measurement of the goods and service to be delivered,
2. unit costs are developed,
3. budget figures are developed based on the level of service as determined by multiplying the unit cost and level of service,
4. expected outputs are reported within the budget.

The performance budget is designed to provide a clearer picture of what level of service is to be provided for how much money and with what results. An example of this would be to add additional information to the Ottawa Hospital budget documents that outline some of the following outcomes:

a. number and types of operations,
b. waiting times for operations
c. cost per operations
d. overhead costs as a percentage of overall budget
e. changes in service levels.

The performance budget is a good step towards costing of services, identifying clearly service levels of current resources and helping decision-makers make a better link between those two when determining future resourcing.
### Traditional Budgeting versus Performance Budgeting

<table>
<thead>
<tr>
<th></th>
<th>Traditional Budgeting</th>
<th>Performance Budgeting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budget Orientation</strong></td>
<td>Money Control</td>
<td>Linking money to program and activities</td>
</tr>
<tr>
<td><strong>Appropriation Control Level</strong></td>
<td>Department</td>
<td>Program</td>
</tr>
<tr>
<td><strong>Basic Budgeting Unit</strong></td>
<td>Object, object code or line item</td>
<td>Activity</td>
</tr>
<tr>
<td><strong>Efficiency Measurement</strong></td>
<td>None</td>
<td>Unit cost, volumes</td>
</tr>
<tr>
<td><strong>Result Measurement</strong></td>
<td>None</td>
<td>Program levels, activity levels</td>
</tr>
<tr>
<td><strong>(Effectiveness/Quality)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Budget Period</strong></td>
<td>One year</td>
<td>Ongoing – year over year</td>
</tr>
</tbody>
</table>

Some of the key elements of performance-based budgets are:

1. services are defined and measures created for them,
2. disaggregating of services permits individual costing and the development of workload measurements
3. service standards are developed,
4. there is a standardized costing methodology,
5. unlike other budget formats, there will be a considerable amount of narrative to explain service levels, how
6. they are costed and how costs are distributed,
7. some form of benchmarking is involved: this provides comparative data of costs and workload levels in similar circumstance, e.g. comparing the cost of garbage collection from one town to another.
Key Points

- A good budget process is far more than the preparation of a legal document that appropriates funds.
- Good budgeting is a broadly defined process that has political, managerial, planning, communication, and financial dimensions.
- A good budget process is characterized by several essential features. A good budget process:
  - Incorporates a medium-term perspective
  - Establishes linkages to broad organizational goals
  - Focuses budget decisions on results and outcomes
  - Involves and promotes effective communication with stakeholders
  - Provide incentives to government management and employees

These key characteristics of good budgeting make clear that the budget process is not simply an exercise in balancing revenues and expenditures one year at a time, but is strategic in nature, encompassing a multi-year financial and operating plan that allocates resources on the basis of identified goals.

Budgets and Planning Cycles

Arriving at the final budget will entail some measure of forecasting, analysis of options, setting in place plans over the long-term and finally assigning resource levels. This is the budget cycle. Understanding how it works is essential for a public sector manager.

Budget cycles tend to be portrayed in calendar form. Below is a typical public sector budget cycles.
Elements of an Effective Budget Cycle

- It creates a common framework for all the players in the process to use.
- The cycle ensures that political priorities are set.
- The budget cycle is linked to the overall planning cycle of the department.
- There is a common approach across government to permit comparison and comparative costing.
- There is an agreed upon timetable for preparation and consideration of budgets within the organization.
- Governments provide guidance to managers on budget limits and important information about tolerable cost levels.
- There is a common costing methodology for common inputs such as staff salaries, equipment, etc.

The elements can be rolled up into three essential phases:
- Strategic Planning Phase,
- Cost Analysis Phase, and
- Approval Phase

Strategic Planning Phase

Strategic plans usually contain a fundamental set of components that describe the purpose of the organization and its intended direction over a prescribed period.
Mission - comprehensive statement expressing the purpose of the organization.
Vision - statement of the end-results pursued by the organization.
Guiding Principles - philosophy that steers the organization in delivering services and accomplishing its mission.
Situation Analysis - description of key internal and external trends that are likely to have an impact on the agency over the time period of the plan.
Goals - statements that describe the agency’s destination, direction, and intent for the period of the plan.
Objectives - initiatives that implement the goals.
Performance Measures and Targets – precise milestones for each objective that will help the organization will evaluate progress toward the objectives and the goals that it supports.
Linkage of General Goals to Annual Performance Plan - description of the relationship between annual goals in the performance plan and the general multi-year goals and objectives in the strategic plan.
Resources Needed - description of the human, capital, information, and other resources and the operational processes, skills, and technology needed to achieve the agency goals; highlighting where significant change from currently available resources will be needed. Note: this is not the budget for the coming year, but a resource discussion that will certainly affect budget decisions in future years.
Program Evaluations - description of how the results of programs or policy will be evaluated.

Cost-Analysis Phase

The Role of Revenue in Cost-Analysis

Managers have to make predictions about anticipated revenues because without understanding what resources will be available to government, it becomes extremely difficult to decide what projects should be allocated resources. Using historical trend data is an easily available and useful tool for predicting revenue. Once a prediction is made, attention could then be made about costs and the spending priorities of government.

How to Determine Costs

One way of examining costs is to divide them into two basic categories: Direct and Indirect.
Direct costs are costs incurred within the organizational unit for which the manager has responsibility, and costs of resources used for direct provision of goods or services or activities that relate to the core mission of the organization.3

Indirect costs or “Overhead” are: costs assigned to an organizational unit from elsewhere in the organization e.g. information technology support, and costs within a unit that are not incurred for direct provision of goods or services, i.e. core business or mission central, but are nonetheless needed to provide those services, e.g. logistical support, information technology, physical plant, financial services.4

Often organizations fail to fully take into account all the costs of service delivery. The objective of sound budgeting practice, however, is to arrive at a full understanding of the total cost of providing the mission-critical services of the organizations. Therefore, both indirect and direct costs need to be included in any budget.

Fixed and Variable Costs

Another essential tool of costing is the use of fixed and variable costs. This analysis is important for it enables the manager to determine how costs will react when certain variables are changed. It can establish cost sensitivity, i.e. the point at which costs can either be reduced or increased with changes in activity. Establishing an understanding of cost sensitivities will enable the manager to better understand the impact of program changes.

Fixed costs are those costs that do not change in total as the volume of service unit’s changes over a relevant range of activity.5 Variable costs are costs that vary directly with changes in the volume of service units over a relevant range of activity.5

Getting Approval to Spend: The Appropriation Process

As the budget process such as described above becomes more institutionalized it engages more players and eventually produces a formal budget submitted to the authorizing authority. In general, this will mean that the final stage of the budgetary process will provide legislative approval of the planned expenditures. The purpose of this authority is to obtain specific approval to spend money. Such authorization is called an appropriation. Appropriations create the authorization for spending the amount in the budget. In this way the budget moves from being a submission for funds, then a plan, then a budget to becoming the legal instrument of the government, which both permits the expenditure of funds and restricts that flow to the levels submitted for approval.

3 Finkler, p. 97
4 Finkler, op.cit.
5 Finkler, p. 99
6 Finkler, op.cit. p. 99
Central Agency versus Program Organizations

Typically, during the budgetary cycle, the overall planning and legislative process is supported by central agencies such as the Ministry of Finance. Central agencies provide a whole-of-government assessment of the supply of revenue as well as the tolerable scope for program expansion. They ensure that debt is avoided by looking at the big-picture of program spending. Central agencies use the analytical tools mentioned above to provide a detailed assessment of the costs of government programs and then provide recommendations to the legislature.

There is an inherent tension between the desires of program departments of government to spend to meet all their program needs and aspirations and the desire of central agencies to control the demands to what is both realistic within government revenue projections and desirable within the government’s overall priorities. Such tension means that program managers will have to work effectively with central agencies if they are to be successful defenders of their program funds or proponents of new funding.

The New Versus the Old

Perhaps one of the greatest sources of tension within budgetary systems and the budgetary approval process is the desire by governments to extract funds from one spending centre and move it to another. While this goes by many names, it is generally known as reallocation of existing funds. This is often a matter of funding new programs with existing funds.

Governments will be continually looking for ways to improve efficiency of current operations to reduce costs. They will also be looking for programs that no longer serve an important public purpose.

Complexity versus Clarity

Budgets are made up of a stream of decisions, somewhat involve spending and some that involve limiting spending. Very few decisions are alike and a variety of political, social and economic factors come into play in their creation. For many public sector organizations, in order to achieve the objective of public involvement and transparency, the budget process can be a long one, involving many different forums, in order to arrive at a final product.

On Budget Versus Off Budget
A challenge for many countries is getting a true picture of government expenditures. Often governments will seek to minimize the scope of public expenditures by taking some expenditure items off-budget. This can be done for legitimate policy and accounting reasons. For instance, if a public sector program is self-funding, such as one that obtains all of its revenues from service fees, it can be said to operate off-budget as it does not take up any appropriated funds from the budget. Often such entities establish financial reporting statements separate from the overall government financial statements. This serves one good of clarity. However, it is also contended that removing it from the general government books distorts the degree of public sector spending. This debate is universal. One element of concern, however, is when off-budget entities are created to deliberately mask or distort either government revenues, e.g. development grants from external sources or remove effective legislative oversight of this part of the public sector.

**Conclusion**

The process of formulating and getting approval for a budget, at any level and in any kind of public sector organization, is an integral part of how that organization carries out its mission. It can be complex or simple, depending on the nature of the organization. However, some common elements for public sector organizations emerge:

- Budgets bring together needs and capacity, often from different parts of the organizations, whether it is tax capacity and program demands or client needs and fund raising capacity of the organization.
- Budgets demand a technical command of the key elements of needs measurement, effective costing of program, revenue projections.
- Budgets in the public sector are legal documents that define expenditures authorities and limit it to those levels once approved by the authorizing legislature.
- Budget making takes place in an organizational culture, rich in nuance, with power playing as much a role of good policy making.
- Budgets are inherently transparent in the public sector, both in terms of how they are formed and in how they are executed.
- Budgets are both the result of planning based on past experience and the existing policy or mission framework of the organization and future orientations.
- Budgets in the public sector are subject to intense scrutiny not only by those who will manage them, but also those who will benefit from or be subject to them.
Key Points

- Capital assets are expensive, have a long life, can lock in an organization in terms of alternative or emerging technology.
- The total cost of a capital asset over time may include sizeable operating expenses.
- Its acquisition can distort operational planning if this is not adequately considered at the planning phase.
- Capital requires some special treatment both from the budgeting and accounting perspective.

Capital Budgets

A capital budget is a plan for the acquisition of buildings and equipment that will be used by the organization in one or more years beyond the year of acquisition. A distinction that has already been drawn between operating and capital budgets is that of time. Operating budgets are appropriated and reported upon for a single fiscal year. Generally, the operating assets are approved and used up with the year. The capital budget, while it involves actual cash disbursements within the course of a fiscal year, more often involves a flow of cash over a number of years to create an asset, which has a life longer than one year at a minimum.

Therefore, both the investment flow and the asset return extend over a considerable period of time. Having capital projects dependent on year-to-year approvals restricts the capacity of the organization to commit to the full cost of the project. Approving the first phase of a major construction investment and then reviewing it entirely while not approving the next phase can lead to a series of complications from waste of public funds to a reluctance to engage in the high risk venture in the first place.

Finally, it is often the case that capital projects involve long-term debt for the organization. The challenge of long-term financing involves a good understanding of the true costs of the investment.

Characteristics of Capital Assets

From an accounting point of view, something is a capital asset when it meets four criteria:

- that they are used in the production or supply of goods and services (productivity criterion),
• that their life extends beyond a fiscal year (longevity criterion)
• that they are not intended for resale in the ordinary course of operations
• that the monetized value of the asset is sufficiently high (materiality principle)

Tools of Capital Planning and Budgeting

Effective capital budgeting begins with an understanding of two elements:

- **Capital Improvements**— the capital requirements of the organization, both now and in the future
- **Maintenance**— understanding of the requirements to maintain present capital assets in a useful state.

Governments struggle on both counts, because of the concern for the costs involved and because they have not always sufficiently seen capital assets as being subject to deterioration and in need of renewal. As well, in the absence of life-cycle analysis and the application of true costing tools such as Time Value of Money and Return on Investment Analysis, capital expenditures are usually seen as an annual expenditure and not an investment flow.

Here are some tools of good Capital Planning

Capital Improvement Plans

A Capital Improvement Plan has a multi-year perspective. It can be renewed and updated rather than re-created each year. In this way, major capital investment depreciation is not forgotten and maintenance issues remain on the table. It is very easy, especially in a political environment, to forget pipes under the ground or the existing buildings in an effort to focus on more immediate crises or the desire to create new capital projects. An example of a critical area in this regard is the need to upgrade roads on a regular basis. It may not be the most politically exciting thing, but it is necessary. And it costs money.

Some of the steps to be following in the creation of a Capital Improvement Plan are:

- **Strategic Relevance**: A statement that links the organization’s goals and objectives to its present and future capital needs
- **Analysis of Factors Affecting the Organization’s Capital Asset Base**: Some factors to take into account in that regard are:
  - **Demographics**: Both current and future indicators, such as population changes by age cohort; impacts of births, deaths, immigration and emigration; and issues specific to program areas.
  - **Program changes**: These include new initiatives, program terminations or changes in program parameters.
o **Technological changes**: Technological imperatives are essential considerations today, especially as business processes become more web-based.

o **Economic or business changes**: These include current and projected financial or market trends and opportunities and emerging trends in the way business is conducted. An example is the emergence of service providers as alternative service deliverers of public services.

o **Legislation**: Factors to consider here include any new statutory requirements affecting the organization or its service plan.

o **Environmental factors**: These include the impact of any potential changes to environmental standards.

o **Inventory and Condition Analysis**: A comprehensive asset inventory, including an assessment of the physical condition, functionality (i.e. ability to support current program delivery) and utilization (capacity) of its capital stock. This should be updated on an annual basis. The following information should be part of this analysis:

    o **Baseline information**: Information on assets such as land, buildings, building systems and equipment, tracking such factors as:
      1. ownership status
      2. location and zoning
      3. structural types
      4. size (land area if applicable, square footage, vehicle capacity, etc.)
      5. age and history (e.g. rehabilitation, repairs, maintenance activity, additions, renovations)
      6. value
      7. current use,
      8. estimated service life; and
      9. any other significant issues such as environmental liabilities.

    o **Physical condition and risk factors**: An assessment or rating of the physical condition of the inventory, including maintenance requirements, seismic vulnerability, asbestos, etc.

    o **Functionality**: An assessment of how effectively each asset meets existing program or service needs; functionality is sometimes measured as the difference between current operating costs and the projected cost of operating a "state of the art" facility.

    o **Purpose or Use of the Asset**: An assessment of how each asset is being used; this is sometimes measured by comparing forecast service demand against an asset’s current capacity

    o **Maintenance Needs**: Maintenance requirements must be identified in capital plans. Plans should also explain the methodologies used to develop the
maintenance forecasts (e.g. measurement tools, standards and formulas based on asset value or square footage).

- **Estimates of Required Resources**: Estimates of capital asset related needs should be aggregated into identifiable categories. The overall capital costs, when outlined thoroughly, can be staggering for public sector organizations. Very seldom do revenue expectations match the straight-line anticipated capital costs. Usually at this point, various priority setting processes come into play.

- **Development of Strategies and Alternatives**: The Capital Improvement Plan (CIP) itself does not provide decisions about capital expenditures. Rather, it is the background against which the public sector organization will set priorities. One important service it can provide is to offer alternative strategies for dealing with capital pressures. For instance, the CIP could also identify alternative delivery forms such as public-private partnerships that would, in essence, transfer the capital costs of a new building to the private sector builder while imposing a downstream operating cost for government in the form of guaranteed rental and payment of debt costs back to the supplier.

**Time Value of Money**

Because capital projects are costly and often involve major government investments, the cost of the project has to be set into the time frame within which governments will incur the costs. At this point, some form of **time value of money** analysis will have to be applied before final spending decisions can be made.

The simplest explanation of **time value of money** is that a dollar today is worth more than a dollar tomorrow or at any time in the future. Partially, this difference in value is attributable to the earning and compounding of interest for a dollar invested today. This is also attributable to **opportunity cost**, meaning that money spent now addresses present needs while money deferred misses the opportunity to do so.

Another factor that relates to the time value of money is **risk**. Risk in this instance refers to possible loss of value of the funds available through an unsuccessful investment in a capital project. The dollar in hand today has no risk. It is firmly within the control of the organization and it can dispose of it, save it or invest it as it sees fit. The promise of a dollar tomorrow carries some risk that you won’t get it or you won’t get it when you have been promised you will get it.

Taking all these elements into account, time value of money considerations encourage managers to calculate the monetized benefits of a capital investment and then discount those benefits in a way that reflects the declining value of a dollar of benefit occurring in the future rather than today.

**Present Value and Future Value**
Applying techniques of interest compounding and discounting, it is possible to determine either the present value (PV) or future value (FV) of a capital investment, using a simple formula that applies interest and time to the amounts that are either available now for investment in capital or the present value of a future payment. The variables used in both calculations are:

\[
\begin{align*}
PV &= \text{Present Value} \\
FV &= \text{Future Value} \\
i &= \text{Interest Rate Per Period} \\
n &= \text{Number of Compounding Periods}
\end{align*}
\]

Present Value is an amount today that is equivalent to a future payment, or series of payments, that has been discounted by an appropriate interest rate. Since money has time value, the present value of a promised future amount is worth less the longer you have to wait to receive it. The difference between the two depends on the number of compounding periods involved and the interest (discount) rate.

The relationship between the present value and future value can be expressed as shown:

**Relationship between Future Value and Present Value**

\[
PV = FV \left[ \frac{1}{(1 + i)^n} \right]
\]

**Example:** You want to buy an emergency generator for the Fire Department that will only become useful 5 years from now for $150,000. Assuming a 6% interest rate compounded **annually**, how much should you invest today to yield $150,000 in 5 years?

\[
\begin{align*}
FV &= 150,000 \\
i &= .06 \\
n &= 5 \\
PV &= 150,000 \left[ \frac{1}{(1 + .06)^5} \right] = 150,000 \left( \frac{1}{1.3382255776} \right) = 112,088.73
\end{align*}
\]
Net Present Value

Net Present Value (NPV) is a means to calculate whether the public sector organization will be better or worse off if it make a capital investment. It does so by calculating the present value of inflows minus the present value of outflows.

\[ NPV = PV_{\text{Inflows}} - PV_{\text{Outflows}} \]

Risk Assessment

It is critical to understand and assess the risk involved in each initiative. Risks should be identified at the earliest stage of planning as they may impact financing and procurement options. Once risks have been identified, they must be analyzed and evaluated to determine the likelihood, consequences and level of risk. Finally, a risk management and/or mitigation strategy must be put in place.

Risks should also be reviewed and updated as the initiative moves forward. The table below provides examples of the risk categories that should be considered when planning and managing infrastructure expenditures. It also provides examples of how these types of risks may be treated to reduce the likelihood or consequences of potential losses.

Examples of Risk Categories in Assessing Capital Asset Risks

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>Description and Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Risks</td>
<td>Examples include high-level concerns related to the decision to undertake an initiative. Risk treatment may include documenting how an initiative fits with established strategic objectives; assessing the requirements for a new corporate structure; enhancing the initiative’s profile with the public, media and governments; and working collaboratively to enhance labour and industrial relations.</td>
</tr>
<tr>
<td>Policy Risks</td>
<td>Examples include the likelihood that an initiative represents, or may be affected by, a major shift in government or agency policy, or change in legislation.</td>
</tr>
<tr>
<td>Public Interest Risks</td>
<td>Examples include the initiative’s environmental impact and its relation to public health, safety and security issues. Risk treatment may include working with neighbours and the community to address public concerns in the initiative planning phase.</td>
</tr>
<tr>
<td>Management or Organizational Risks</td>
<td>Examples include the complexities associated with partnerships, investments and management. Risk treatment may include managing dependencies on linked funding and contingent investments; ensuring the availability of qualified initiative managers; and ensuring the initiative development team has access to appropriate expertise when undertaking a new type of initiative.</td>
</tr>
</tbody>
</table>

7 BC Capital Asset Management Framework
Design/ Construction, Commissioning, Partnership or Supplier Risks

Examples include sponsor risk (e.g., the likelihood that a private partner may be unable to deliver) and general supplier/market capacity. Risk treatment may include ensuring the availability of material and equipment supplies; ensuring that experienced designers, contractors and trades people are available in the required time frame; anticipating the need for community permits and approvals; and designing construction windows to avoid delays due to adverse weather.

Political Risks

Often unspoken, but certainly real are many political risks associated with capital projects. Examples of some are:
- short tenure of a government that may mean the project is re-evaluated or changed by a new government,
- local opposition to a project that leads to considerable political controversy and reversal on grounds of community concerns
- failure to adequately consult or take into account various stakeholder interests

Site Risks

Examples include the risks associated with site selection and acquisition. Risk treatment may include ensuring that the site is available at an affordable price; evaluating site challenges such as soil contamination or potential flooding; and ensuring the desired site is free of potential land-claim issues.

Financing Risk

Examples include an entity’s ability to draw the required financial resources and the overall financial viability of the initiative. Risk treatment may include ensuring that financing is available at the appropriate time; anticipating the impact of interest rate increases; and evaluating the creditworthiness of potential partners.

Cost, Economic or Market Risks

Examples include all possible events that could affect cash flow during initiative development. Risk treatment may include planning for contingencies in the market such as a drop in demand for services; anticipating the potential for labour or material cost escalations; ensuring funding is available to cover operations, maintenance and administration; and assessing the potential for competing facilities.

Ownership and Operations Risk

Examples include labour relations, maintenance, and technical and asset obsolescence risks. Risk treatment may include taking steps to keep maintenance in line with forecast levels and taking appropriate measures to address the likelihood of abandonment.

Other Risks

Risks that could be substantive and require resolution and/or management prior to commitment to the expenditure, or during delivery, including uncontrollable “force majeure” risks such as weather and global uncertainty. Risk treatment may include developing contingency plans to avoid or reduce construction delays due to emergencies or disaster; and ensuring that business continuity plans address a wide range of potential events.

Conclusion

The conceptual tools and planning processes suggested here is an important part of organizational financial management wherever capital plays an important role in carrying out that organization’s mission. Thinking about capital often challenges the line manager to escape the year-to-year operating budget orientation and look at the implications of such elements as the actual cost of an investment in capital for both operating costs down the road and further capital investments.
One of the other very important reasons to have a special awareness of capital budgets and how capital behaves over time is that often in government, the issue of maintenance and replacement of capital goods is easily deferred when difficult budget cuts have to be made. What this has led to in some countries is a serious underinvestment in infrastructure that will now cost much more, in present value terms, to replace. This has been the victory of the short term over the long term. Unseen sewers very seldom attract political attention – until they break down.
Section 5: Cornerstone Two: Monitoring Money—Managerial Control

Key Points

The budget is a plan. Once approved, it has to be carried out. The desired outcome of implementing the budget is to achieve the objectives of the program, project or line of activity in the most efficient and effective means that are reasonable to the situation but with an equal concern for the proper use of public funds. In any enterprise, this requires a series of controls. Taken together, these form a full control framework. Control begins and ends with a focus on the ends to be achieved and how to monitor performance.

For the line manager, controls establish the extent of their discretion and outline the rules by which to make decisions. Effective controls will ensure that there is a timely understanding of the performance within the organization that would permit adjustments in budgets, behavior, or program expectations to accommodate unforeseen situations and monitor the impact of managers’ decisions.

What is Management Control?

Management control systems consist of all organizational structures, processes and subsystems designed to elicit behavior that achieves the strategic objectives of an organization at the highest level of performance with the least amount of unintended consequences and risk to the organization.8

Management Control Framework

A control framework is a way of describing the architecture of control for the organization. A control framework within an organization will involve certain key features:

- Establishing the organization’s goals and objectives
- Assigning roles and responsibilities.
- Performance standards where they can be established.

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8Systems Theory and Management ControlBy: Dr. Shahid Ansari:
• An understanding of the risks inherent in the program and the environmental in which it is taking place
• Positive mitigation and monitoring tools to continually reassess the risks
• A series of control procedures and policies to both address the risks identified and to satisfy certain legislative or policy-created requirements for adequate control
• A system of monitoring at both the operational and financial level to ensure that the organization fully understands what is happening relative to its goals and the risk environment
• A system of auditing and evaluation, both internal and external, that provides assurance, from an independent perspective, that there is an adequate control framework, that it is working (and not just paper) and that the outcomes, both operational and financial, are as the organization claims.

**Risk and Risk Management**

In many ways, actually exercising control means anticipating and mitigating risks within the organization or program. Control is about Risk Management. Risk and risk management have both a narrow definition associated with financial loss and a larger, more comprehensive one associated with organizational goals and the threats to attaining them. In the context of financial management, risk management encompasses both.

Nonetheless, risk can broadly be defined as follows: any threat, event, pattern of past or anticipated behaviour or predicted event that could deter the organization from achieving its goals.

In applying this definition to public sector financial management, there are clearly some conditions that have to taken into account. First, the goals of all public sector organizations are to perform a public good in the manner prescribed by law or policy in a cost effective manner. Second, it is possible to readily interpret this definition in financial terms in a number of ways:

• The danger of not managing entrusted funds effectively or legally,
• The danger of inadequate funding combined with exaggerated objectives,
• The danger of spending over budget without taking mitigating measures,
• The danger of fraud or misuse of funds,
• The danger of unforeseen circumstances that strain or threaten the financial capacity of the organization,
• The danger of loss of confidence from the public, the legislature, donors or stakeholders in the capacity of the organization to deliver its services as promised.
Risk management, therefore, is the establishment of procedures and management systems to identify, assess, validate, mitigate and monitor risks to the organization in such a way to eliminate them, effectively reduce their impact or be prepared to respond to them.

**Understanding and Defining the Risks**

A key part of risk management involves the need for managers to make decisions about what risks to act on and which ones do not require any action at the time of review.

Not all risks are the same. It is necessary for the organization to decide which ones are important and demanding of a certain level of mitigation and which ones are either not a significant threat, not timely or easily mitigated if they do occur.

A number of systems have been established to help organizations determine the level of risk that they can accept. Such systems are valuable as they establish a common language and framework for organizations to effectively come to an understanding of the risks they face and the meaning of their identification of them. Ensuring that all levels of the organizations use such common tools ensures that misunderstandings about risks and the control needs that may flow from them are reduced.

Below is a standard grid to enable organizations to rank risk on two key axes: impact and likelihood. Without determining what the likelihood and potential impact of any identified risk, there is no reasonable way to determine what to do about the risk. Further, this is the key way to differentiate risks and determine where to apply scarce managerial resources in the mitigation process.

<table>
<thead>
<tr>
<th>IMPACT</th>
<th>POTENTIAL RISK MANAGEMENT ACTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significant</td>
<td>Considerable management required</td>
</tr>
<tr>
<td>Moderate</td>
<td>Risks may be worth accepting with monitoring</td>
</tr>
<tr>
<td>Minor</td>
<td>Accept risks</td>
</tr>
</tbody>
</table>

| LIKELIHOOD | | |
|------------|------------|
| LOW | MEDIUM | HIGH |
Control Procedures and Policies

Who and When to Control

Now that we have an idea about where our objectives may be compromised through a risk identification process, we need decide how to achieve the kinds of controls that are needed. The act of controlling financial resources is an active one that both the manager of the program and the financial experts have be engaged in. It cannot be left to finance to provide all the control oversight. It is too closely tied to the manager’s responsibilities to deliver the public good for which he or she is responsible.

The first control question to ask when contemplating the means of control is: who to control and when to do it.

In terms of who to control, there are two choices: the organization as a whole or an individual. The individual may be a person within the organization who is making a decision to spend funds on behalf of the organization. Alternatively, the individual may be the recipient of a public good or entitlement. In many cases, when the organization is to be the subject of control, the controls will entail information at an aggregated level of performance, e.g. quarterly reports on contracts authorized and levels. If it is an individual, it may be at the individual transaction level.

In terms of time or when to control, the alternatives are to exercise control either before or after the individual or organization has acted. Before-the-fact, or ex ante, controls involve subjecting a decision that the organization or individual is about to make to some level of approval or review in advance. As an example, an organization may require approval from its central office before purchasing equipment over the value of $50,000. This approval is a form of control and required because of the materiality of the purchase. This is in spite of the fact that purchase of this item may have been approved as part of a larger budget plan.

After the fact, or ex post, control involves a review process for decisions and expenditures that have already been made. In such circumstances, the actor, be it the individual or the organization, is fully responsible for the action that was taken, as they had the authority to approve it and action was taken as a result of their authorization. For example, a cheque may be issued on the authority of an individual, not subject to any other review, except to verify that it is the approved official who has that authority. However, some form of control, through monitoring, sampling, summarized reporting or variance analysis, is put in place to oversee the quality of decisions already made either at an individual, or aggregate level. This is the more common form of control exercised over financial transactions within organizations. It is more efficient in terms of processing payments, etc. it also focuses prior approvals on the riskier transactions, thereby effectively budgeting senior management and governancen time.
Who is the Controller?

The next question to ask is who the controller is. The simple fact is that controller/controllee relationships exist at many levels and operate in many ways. Therefore, while one manager may exercise control over a group of staff and set up processes of control such as regular performance reviews, delegation to limits to define discretion, etc., that very manager will almost certainly be subject to controls both from a superior and also from oversight bodies such as external auditors. Another point is that they are imperfect and often clouded by other matters, be they operational, financial or political.

Trust and Ethics in Control

If risk management is the face of control—the way in which control is expressed—than trust and ethics are the heart of control—the cultural reality that either support or destroy even the most perfect control plan.

Fundamentally, all controls are built around two notions:

- the degree of trust the controller places in the organization or persons with authority and responsibility, and
- the assumptions about ethical behavior in the culture and legal framework of the organization.

Trust

Trust is a calculation that is made by the organization about its own people, about other organizations and other people as well as its leadership. Trust is also an important element in balancing the desire for full assurance through control (no surprises, no errors) with the cost or improbability in achieving it. In the end, more control systems, no matter how technologically sound or detailed, depend on the people running them and operating within them. Therefore, a degree of trust is necessarily extended to operators of the systems with the assumption that their intentions are sound and that, based on their track record, such trust is deserved.

Ethics

Not all control is about systems, procedures, documentation and process. In fact, all of this control could be happening and, with the wrong values in play, serious intrusions into pubic trust could be accruing. This could be either through misappropriation of public funds, using them for purposes not intended or their diversion to other purposes of a personal nature. It is axiomatic that the public sector organizations and the people within them have to act in an ethical manner.

Therefore, ensuring that the ethical framework of the organizations and its personnel is sound is yet another form of control, one that is essential to the success of all other efforts.
One of the most important elements of establishing strong values and ethics is through ethical leadership within the organization. Note that this is the first item identified by the OECD in its framework for ethical public sector organizations, as listed below:

**Values and Ethics Approaches**

- Political and senior management leadership that promotes ethical conduct
- Clear statements of values and ethics or codes of conduct
- Approaches to decision making that
  - require consideration of values and ethics
  - align management policies to support ethical conduct
  - offer recourses to report ethical concerns
- Clear guidance for interaction between the public and private sectors
- Assessment of and reporting on effectiveness of values and ethics initiatives

**Source:** Organization for Economic Co-operation and Development (OECD), *Principles for Managing Ethics in the Public Service*

The attributes of ethical leadership were documented by the Canadian federal government’s Task for on Public Service Ethics:

- **Create a supportive work environment that**
  - values people, treating them with dignity, civility and fairness;
  - emphasizes openness and the sharing of information;
  - promotes honest and collegial leadership;
  - encourages and supports speaking truth to power; and
  - supports a balanced family and work life.
- **Make decisions that**
  - serve the public interest;
  - respect democratic principles and the rule of law;
  - ensure due process, impartiality and objectivity;
  - provide effective services to citizens; and
  - promote transparency, probity and accountability.

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Some of the tools that public organizations can and do use to ensure that they have promoted ethical behaviour are:

- establishing codes of conduct or ethics to signal the important values of the organization
- supporting sanctions for ethical misconduct
- using merit principles in hiring and promotion
- a wide variety of training initiatives on ethics for both new employees and those already in position
- identification of high risk positions (not persons) where either special training on ethical challenges or special surveillance is called for
- disclosure of any conflicts of interest and policies to support this, noting that this becomes more important the higher the level of the position,
- tools to report misconduct of superiors and adequate safeguards for those reporting, i.e. confidential channels and whistleblower legislation
- Ombudsmen positions
- ethical counselors, trainers, offices
- the involvement of professional associations, such as CICA, to develop ethical guidelines for membership

Clearly, control does not happen without adequate values and ethics to support it. Therefore, addressing ethics as part of an overall control strategy makes good sense and is probably less costly that more regulatory measures.

**Controllership Capacity Checklist**

According to the Treasury Board of Canada there are seven key areas of controllership, all of which have been discussed implicitly or explicitly above.

The seven key areas of the *Comptrollership Capacity Check* are:

**Strategic Leadership**

- **Leadership commitment**: Awareness and commitment of deputy head and senior management to establishing and implementing a modern management practices environment
- **Managerial commitment**: Awareness of managers of their modern management practices responsibilities, and commitment to implementing them
- **Senior departmental functional authorities**: Extent to which senior departmental functional authority and supporting organization are used for objective commentary and independent advice
- **Planning**: Strategic, business and operational planning, and the linkages between them and to resource allocation
- **Resource Management**: Mechanisms for ranking program options, identifying funding requirements and allocating resources, and budgeting and forecasting
• **Management of partnerships**: Partnerships are used extensively by the organization in support of service delivery by leveraging the capabilities of external stakeholders, partners, and other government organizations

• **Client relationship management**: Commitment to consciously strengthening relationships with client organizations, and to integrating and coordinating how client services are developed and delivered

**Clear Accountability**

• **Clarity of responsibilities and organization**: Clarity of assignment of responsibilities and accountabilities throughout the organization

• **Performance agreements and evaluation**: Extent to which the achievement of financial and operating results is embedded in performance agreements

• **Specialist support**: Availability of top-flight counsel to help managers make judgment calls on modern management and operational issues

• **External reporting**: Extent to which Parliamentary, central agency and key stakeholder information reporting requirements are met

**Shared Values & Ethics**

• **Values and ethics framework**: Leadership of policies and activities that visibly support the ethical stewardship of public resources and give priority to "modern management practices"

**Mature Risk Management**

• **Integrated risk management**: Measures are in place to identify, assess, understand, act on, and communicate risk issues in a corporate and systematic fashion

• **Integrated management control framework**: Appropriateness of management controls in place, and linkages between controls through an integrated control framework

**Integrated Performance Information**

• **Integrated departmental performance reporting**: Key measures exist to monitor overall organization-wide performance and best-value results

• **Operating information**: Measures and systems to monitor service quality and efficiency of program delivery

• **Measuring client satisfaction**: Utilization of client survey information on satisfaction levels, and importance of services

• **Service standards**: Monitoring against client service standards and maintaining and updating standards

• **Evaluative information**: Utilization of non-financial information related to program effectiveness and outcomes

• **Financial information**: Reliable financial information is available in a timely and useful fashion

• **Cost management information**: Mechanisms for using activity/product/results-based costs

**Motivated People**
• **Modern management practices competencies**: Extent to which modern management practices competencies are defined and managers have access to training

• **Employee satisfaction**: Mechanisms in place to monitor employee morale and staff relations

• **Enabling work environment**: Practices for communication, wellness, safety and support that enable staff to provide client-focused delivery while reaching their full potential

• **Sustainable Workforce**: The energies of staff are managed wisely to help sustain the organization’s viability

• **Valuing peoples’ contributions**: Extent to which the organizational culture fosters staff participation, team building, sharing of ideas, risk taking, innovation, and continuous learning; and rewards or provides incentives for such behaviour

Rigorous Stewardship

• **Business process improvement**: Extent to which processes are clearly understood, are conducted in a uniform fashion, and are continuously improved in line with best practices

• **Management tools and techniques**: Range of analytical techniques (e.g., cost-benefit, sensitivity, life cycle, benchmarking) available to managers

• **Knowledge management**: Performance/management information is readily accessible to internal and external users via technology, and lessons learnt are shared across the organization

• **Accounting practices**: Records of financial transactions are kept on a consistent and useful basis for purposes of audit and reporting, and are consistent with generally accepted accounting practices and the Financial Information Strategy (FIS)\(^\text{10}\)

• **Management of assets**: Assets are managed and utilized efficiently based on a lifecycle approach, records of assets are maintained, and assets are accounted for on an accrual basis according to GAAP/FIS.

\(^{10}\)In explaining what the FIS is, the federal government of Canada, states the following: “FIS is a government-wide initiative designed to enhance decision-making and accountability across government, and improve organizational performance through the strategic use of financial and non-financial performance information. The three key components of FIS are:

**Systems** - the introduction of new modern integrated information systems;

**Policies** - the adoption of full accrual accounting similar to what is practised in the private sector;

**People** - a cultural change focused on enhanced analysis and use of information.

Accounting is only the starting point. The greater goal of FIS is to bring about all the attendant changes in systems, policies and people. Ultimately, FIS aims at nothing less than changing the culture of resource management in the Government of Canada.”

• **Internal audit:** Strong internal audit program is in place, and audit results are a critical input to management decision-making

• **External audit:** Process for ensuring adequate attention to results and recommendations of external audits of department operations
Section 6: Cash Management: In-Year Control

Key Points

In addition to, *ex ante* and *ex post* control tools, there are also tools of control within the current year management of resources. This is real time control, when the issues can be quite visceral for an organization. Will there be enough cash to pay the staff at the end of the month? Are we on target for our budget projections? How do we find resources for this unexpected emergency? Where can we find funds to meet some short term demands that are well within our mandate and authority, but that we have not allocated funds for? What will we do with this unexpected surplus due to a drop in program levels that we had not expected?

Many of the answers to these questions are contained in a process known as **cash management**. Some of the keys to good cash management are:

- effective cash flow projections and forecasting in order to assess the organization performance against plan and budget,
- reports to the appropriate authorities to alert to changes, confirm that the budget will be spent according to plans, release surplus funding for reallocation and monitor managerial performance to make adjustments in the short term
- governance procedures to ensure the timely review of financial and performance information and to make decisions to adjust programs, reassess budgets or find alternative strategies such as increasing cash available or reallocating funds not needed.

In essence, cash management embraces a broad range of control practices associated with the monitoring of financial performance within the current fiscal year (in-year) to assure that adjustments can be and are made to accommodate changes in relation to the plan and budget.

Objectives of Effective Cash Management, Monitoring and Control

The objectives of creating a system for organizational cash management are:

- To have funds to pay the bills, i.e., sufficient liquidity
- To use budgeted resources for their program purposes and not leave needed funds unspent
- To keep within the appropriated or authorized budget
- To have the organizational and resource capacity to react to changes in plan
• To reallocate available funds to meet emerging, short-term priorities.

Establishing a Cash Management System

Once there is a basic understanding of cash inflow, you can now move onto developing cash management system. Beyond simply focusing on sources of cash and focusing on in-year budget management, a cash management system will have the following elements:

• An appropriated budget
• Build in changes and modifications to the approved budget to create an adjusted budget
• Cash flow projections over the budget period: the in-year cash flow or expenditure plan
• A system of measuring actual financial performance in relation to the projected plan
• A system of monitoring performance, identification of variances and reporting results at the appropriate level
• The capacity for management discussion and analysis of the results and variances
• A governance mechanisms that would
  o review the results,
  o assess variances,
  o determine adjustments needed and
  o make decisions needed to affect those adjustments.

In the cycle above, roles and responsibilities will vary depending on the organization, but any cash forecasting, monitoring and management system will involve a combination of interests and tasks:

• Senior management must set budgets and program direction,
• Resources should be allocated as fully as possible, with exceptions such as reserves and hold-backs against uncertainties,
• Line managers must manage the resources they are given to carry out programs,
• Financial advisors must provide information for decision making to budget setters as well as advice to line managers about their budgets,
• Financial advisors must also provide information and analysis to identify variances, offer comparisons and further analysis of budget perform and make recommendations to line managers and senior managers,
• Financial advisors must prepare reports for senior managers to make decisions,
• Line managers must respond to variances against plans with explanations, solutions and alternatives, and
• Senior managers must determine what actions to take based on these two sets of inputs.
Fortunately, for many government organizations, the issue of cash inflows is not one that they have to address. Budgets are set in a predictable manner and the manager does not have to be concerned about finding the money to meet the obligations.

The focus is on the cash management of expenses that are detailed in the operating budget of the organization. This usually encompasses funds for staff, benefits, supplies, equipment and operational funds, be they for disbursements to individuals, various elements of the care and support to clients, or the purchase of services to meet program objectives.

In-year Budget Design Factors

When preparing for cash management of expenses and thus designing an in-year budget plan, you must take into account the following factors:

- **The degree of detail needed**: Should the plan be based on the approved line items in the budget? Should it be at the responsibility head level or more disaggregated or aggregated? For instance, the responsibility head may have four units performing essentially the same duties but in different locations and with somewhat different staffing patterns. The responsibility head may want to project expenditure patterns on a unit-by-unit basis to permit her to better monitor and manage each unit’s management of its resources. She, in turn, may only be asked to prepare a plan for all her unit.

- **The period frequency**: Is the plan to be built on a monthly or quarterly basis? In high risk areas, the reporting may need to be even more frequent. Here the issue has to be materiality - just how important is it to know the pattern of expenditures at this level of time detail?

  **The role of budget caps or conditions**: One challenge for budget managers is that the senior line or staff managers at the corporate level may intervene in the approved budgets to limit the manager’s discretion or to set an expenditure target below what the budget permits. Perhaps the lesson that is most important in creating budget plans is that formally approved budgets are always potentially subject to modification and management by higher authorities within the organization.

- **Reserves or hold-backs**: Does the organization distribute the full budget to the responsibility centre managers or is some held in reserve to be distributed later on in the year based on need and merit? This is a complex cash management question. Organizations follow many different routes with an eye to enforce good management and to also have flexibility to respond to emerging issues at the corporate level. Such issues in the public sector are often political and short-term in nature. Others are catastrophic events demanding massive and timely resource responses.

Estimating Work Flows

Managers who are asked to submit budget forecasts are really estimating the work flow in the organization that they can achieve with the funds they have. They are assessing the
environment, measuring risks and setting in place their best predictions of how resources will be spent.

Use of Historical Data

It is often argued that operational managers in the public sector face a number of demands that they cannot predict. While this is true, the exercise of budget forecasting is not to deal with exceptions, but rather with rules. Rules include those imposed by the organization for how the manager will manage funds in the coming year, but also the rule of history which is that, all other things being equal, organizations will repeat their behavior unless they make specific moves to change it. Therefore, the best predictor of how funds will be spent in the future is how they were spent in the past. Historical data within the organization should be a guide for forecasting future behavior.

Monitoring Financial Performance and Variance Analysis

The reason for all this detailed planning and projecting is so the organization is able to have the capacity to respond to changes in its environment, deal with unexpected outcomes and maximize the use of the limited resources at its disposal. To do so, it must have information about what is going on, how it is performing relative to its expectations and where it has to focus its limited corrective capacity should the situation in one area reach a critical stage where changes are required.

The organization therefore must establish and use reporting systems that provide information for decision making about cash management. Usually, this will be coordinated by the central financial group, along with whatever staff support units have a strong interest in arriving at decisions about resources.

The questions that the reports must answer are:

- Are we going to be within our budget allotments?
- Are we operating according to our budget plan?
- How does our performance compare with relevant historical data?
- Does this performance mean that more funds may be necessary or that some funds may become surplus in this area and available for reallocation?
- What are the variances and why have they occurred?
- What is the responsibility centre manager going to do about the negative variances?
- Are positive variances within a retention range for the local manager or are they available for other needs outside the unit but within the organization?
- Do we have the needs and authorities to reallocate these funds?
- What does this information tell us about the performance of the manager in this unit?
- What does this information tell us about the long-term funding?
Setting up a Monitoring Timetable

All organizations receive regular financial reports. Most organizations will want to establish a pattern of review that makes it possible to gather performance and financial data on a regular basis with some certainty and in a standard format. Developing the right format takes some time and experimentation for organizations. Generally, a quarterly review is enough to permit the organization to identify areas of both cost over-runs and potential surpluses.

Governance

The cycle of cash management reporting should coincide with how the organization governs itself. Therefore, if timely financial performance information is provided to senior management, they should be in a position to do something about it in a timely and useful manager. Receiving quarterly reports but not having them analyzed and considered for decision-making will possibly meet some bureaucratic need but produce few results. Therefore, reports should be prepared for senior management so that they are in a position to ask and get answers to the types of questions that are listed above.

Performance Reports

The nature of the financial performance reporting will vary from organization to organization. In some cases, the information will simply be the comparison of budget plan to actual performance done on a quarterly basis. In others, more detailed operational information will be provided. The following example of the Eastbrook Correctional Facility looks in detail at two particular line items: staff costs and overtime for this federal correctional facility.

Budget Figures

**Eastbrook Correctional Facility, Eastbrook, Nova Scotia:**

*Quarterly Financial Report, December, 2007*

**Staffing and Overtime, Custodial Staff Only**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Staff (Custodial)</td>
<td>225</td>
</tr>
<tr>
<td>Average Salary</td>
<td>61,000K</td>
</tr>
<tr>
<td>Total Budget Cost</td>
<td>13.725K</td>
</tr>
<tr>
<td>Adjusted Salary Budget (Operating Target)</td>
<td>12.900K</td>
</tr>
<tr>
<td>= 211.5 FTEs(^{11})</td>
<td></td>
</tr>
<tr>
<td>Total Overtime Hours Budgeted</td>
<td>54,900</td>
</tr>
<tr>
<td>Total Budget (Full Allocation)</td>
<td>2.745K</td>
</tr>
<tr>
<td>Average Cost per Overtime Hour</td>
<td>50</td>
</tr>
</tbody>
</table>

\(^{11}\)FTE = Full Time Equivalent
Below we see a report on performance against the figures in the budget plan. This is a form of report that determines if there is a variance against plan but provides little explanation with respect to its sources.

**Staffing: Plan versus Actual**

![Staffing: Budget versus Actual](image)

**Variance Reports**

When information is submitted in the format above, it begs many questions. Normally, the organization will identify that there is a difference between the planned and actual budgets. This is the variance report: a report that specifically identified differences in financial and operational behaviour from what was expected by the organization. It is important to determine the materiality or importance of the variance. By this we mean that the differences are such that some form of reaction will be needed.

**Forecasted versus Actual Report**

The principal issue for these reports is that only material and substantial variances are reported and submitted for action, either by the responsible manager or by superior levels of the organization.

**Analysis of Key Variances Report**

Due to the need for contextual information, forecasts of plans versus actual must be accompanied by an analysis of why differences or variances occur or are anticipated. From the financial side, a number of analytical tools are useful to set the variance in context:

- Historical comparisons
- The cost of the variance to date, i.e. how much of the actual budget has been spent
• The projected variance should nothing change, i.e. the straight line projection
• The variance in comparison to similar units in the system

The manager must also analyze:
• What caused the gap between expectations and results?
• Workload determinants that changed in actual performance
• Inefficiencies that remain
• Limitations of the budget itself
• Actions that could be taken to correct the situation
• What does the trend look like: is it in the right direction?
• Is this isolated to this unit or a general phenomenon?
• Did we set realistic targets?
• Can we fund the shortfall that we see emerging?

**Historical Information**

Reference has already been made in this Chapter to the utility of historical comparisons in terms of looking at predictions about future spending and in examining variances.

In the information provided on the Correctional Facility, no such data was offered. Only information for the current year is presented. However, it can be readily made available in a number of ways. One means is to look at annual staffing levels on a yearly average basis. The figure below provides such information. One interesting fact that emerges from having this information and combining it with the performance in one year is that, even though we know the actual staff levels are higher than planned this year, they are actually the lowest they have been for several years.

**Historical Staffing Patterns: Custodial Only: Year Average**

![Historical Staff Levels Graph]
The relevance of this information is that the reductions in salary costs that senior management wants is, generally, on track.

Reallocation and Readjustment

The final phase of the cash management cycle involves making adjustments to the available cash or funds for the manager’s use based on the variance reporting and analysis. This is an organizational governance function that makes the process truly a financial management exercise and not simply a matter of providing financial reports that do not get used. It must also engage all managers and not simply financial experts because allocation decisions alter programmatic outcomes.

The Authority to Reallocate

In general, public sector budgets are approved at a general level by the authorized legislature or Board, which permits a fair amount of internal reallocation within the budget. For example, general administrative funds are not broken into operating units by the legislature. They are distributed by the departmental senior management and, as such, they can be reallocated. However, certain barriers to reallocation may exist and may create a situation where the organization has funds to meet needs but cannot use them. Some examples of such rules are:

- Funds specifically voted for a single program
- Rules created by central agencies that forbid the reallocation of certain funds, e.g. the movement of capital funds to operating or the transfer of supplies or equipment funds to salary dollars
- Specific ministerial or political commitment that funds designated for a specific program will only used in that program
- Restricted funds created by special purpose endowments or with rules that the funds cannot be moved from one fund to another.

The senior management of the organization has to know not only the formal rules governing the reallocation of funds, but also the dynamics of reallocation. This requires some judgment about what the reaction will be of specific stakeholder groups to the redirection of funds that were designated to an area of interest to them.

Freeing Up the Funds

Committing the funds means that the manager, in a cash environment, will indicate that the funds under his or her responsibility will be spent. The nature and firmness of these commitments is something that the financial advisors within the organization need to spend time considering. A commitment that involves an approved contract is certainly firmer and less changeable than a commitment than is earmarking money to be spent later in the year.
Senior management, seeking to resolve a series of financial challenges, may ask managers to review their commitments to see what funds can be freed up. In parallel, they may ask the financial advisors to do the same, to create a challenge function.

As well as looking at individual manager’s budgets within the organization for reallocation, there is the possibility of using such tools as reserves with controls on the release of funds and corporate hold-backs that hold a certain percentage of the funds until need is well established in the year. These are generally created to give senior management some flexibility. The question of when to free them up is one of timing and competing demands. One of the problems in using these up too early reduces flexibility later in the year.

**Conclusion**

The degree of risk and need will probably dictate the kind of cash and budgetary monitoring that occurs throughout the year. In addition, the degree of interest by senior management in financial issues will also be an indicator of the amount of time that they want to spend on it. However, effective public management means being increasingly aware of the relationship between resources and their use. Setting up one element of a financial management system, using the transactional, lower management side without the other – the oversight and governance – sends signals within the organization that the effective use of resources is not that important.

In making a cash management system effective, it must be seen to have the attention and support of senior managers. While the danger always exists that such processes will drag senior managers into too many details of operations, they must have information at the right level that is useful to them in making decisions about the cash situation of the public organizations.
Section 7: Cornerstone Three: Reporting On How Money Is Spent—Accounting

Key Points

In order for financial management to occur and in order for public trust to be maintained, you need to make decisions based on good and accessible financial information. To get good and accessible financial information you need accounting.

Public sector accounting is an activity with four key characteristics:

- It relies on a set of principles that guide the collection and reporting of financial information.
- Produces tangible outputs called financial statements which reduce all transactions into monetized terms and in so doing try to communicate trends in a government’s financial performance.
- It is not an end in itself. It is a retrospective tool for managers to control the internal activities of the organization by allowing users to determine performance against plans.
- Is of interest to everyone (bureaucrats, politicians, and citizens) because it tells the story of how public money—everyone’s money—is being spent.

In this section, we will try to explicitly focus on the first two of these characteristics—principles and outputs.

Accounting Principles

A set of basic principles exist referred to as Generally Accepted Accounting Principles (GAAP) guide how financial information will be created, reported, audited, and generally understood. Around the world, a number of boards or organizations are involved in setting accounting standards and in defining exactly what GAAP means and how it applies in a variety of circumstances.

In Canada, for example, the standard-setting body for all levels of government is the Public Sector Accounting Board (PSAB), which is part of the Canadian Institute of Chartered Accountants (CICA). In order to be credible and understandable to the public, financial statement from the government must comply with the standards of PSAB. Here are nine of the GAAP Principles in Canada:

1. The Entity Principle

In creating financial reports, the first task is to define the unit, or entity, that is being reported on and include anything that is related to that entity. For example, in reviewing
the financial statements for the City of Ottawa, we must be able to assume that the information we are looking at deals exclusively and completely with the entity we know as the City of Ottawa. Therefore, an employee of the City’s government cannot buy some building material for his own use and record that material as part of the City’s equipment inventory.

Defining the entity permits the organization to create a budget for it, measure and monitor its use and report retrospectively with confidence that it is providing full information on the behavior of the budget, its managers and the objectives for which it was set in place.

2. Money as a Measure/ the Cost Principle
All financial information must be recorded in terms of the money collected or expended. Accounting recognizes only those activities that can be expressed in monetary terms. The advantage of this principle is that it is able to pull together seemingly dissimilar information, e.g. staff, supplies and rentals, and then express it in a single language— that of money.

The monetization or cost principle permits an organization to develop an understanding of the value of its assets, using the common language of cost. This principle is used whether or not actual money changed hands in a transaction. For instance, if a government received gifts in kind such as medical equipment, for the purposes of its financial accounting, it will place a monetary value on those goods.

The most commonly used tool in placing a monetized value on an asset is the historic cost, should that information exist.

3. The Going Concern Principle
This principle assumes that an organization will continue to operate for the foreseeable future. Assets are then treated according to what is expected to happen over the normal course of operations. They will be expected to depreciate in value or be amortized according to reasonable expectations about how they will decrease in value, e.g. 20% of historical value each year for 5 years.

4. The Conservatism and Cost Concept
This principle requires that accountants value assets at the lower of their historical cost or market value. GAAP holds that the accountant, and by extension, the organization, will accept the least optimistic financial position. This has been described as a principle in which accountants recognize no gains until they happen but record all possible losses even before they take place. Hence, when in doubt, it is better to overstate expense and understate revenue.
5. The Matching Principle

The matching principle states that all expenses must be recorded in the same accounting period as the revenue that they helped to generate. When expenses are matched with the revenue they helped to produce, external and internal users of financial statements can make better judgments about the financial position and operating performance of the organization.

6. The Consistency Principle

This principle holds that the organization, once it has adopted a set of accounting and financial reporting standards, will continue to use them to permit consistent comparisons between time periods. Organizations have options with respect to how they value assets and report expenses. Once they have decided how to do this, they should continue to do so. When they change them, they have to provide what is a called a ‘cross walk’ to explain where changes have been made.

7. The Materiality Principle

In the context of financial management, when a revenue source or expenditure is said to be material, that means it is an amount substantial enough that it is a determining factor in financial decision making. Accounting standards apply only to material items. In some cases, it may be appropriate for the organization to take a simpler more practical approach, rather than spend time and effort applying the accounting standards to immaterial amounts. For example, the organization may establish a dollar threshold for capitalizing capital assets. Capital expenditures below this threshold would be expensed instead of capitalized on the grounds that they are not material, even in total.

Materiality is also linked to the financial risks that the organization sees as important. For instance, many government organizations will ask for detailed information and reporting on contracts with private providers, usually setting a threshold below which these reports are not needed. This threshold, e.g. $10,000, is seen as a risk factor above which more information and control is needed. This is a form of materiality.

8. The Duality Principle

The concept holds the following equation as key: assets equal liabilities plus equity. It matches assets with liabilities and funds, providing the system with internal checks by relating each inflow to an outflow in the organization.

This principal expresses itself in the practice of double entry accounting. In double-entry accounting, every transaction has at least two balancing journal entries of debits and credits, where debits must always equal credits. Double-entry accounting keeps "the accounting equation" in effect and is the basis for all accounting systems. Every transaction affects at least two accounts, since there has to be at least one debit and one credit for each transaction. Entries that are not made to a balance sheet account are made to an income or expense account.
9. The Accrual Principle

The accrual principle demands that:

- Revenue recognition takes place when goods and services are provided even if payment has not occurred
- Expenses are recorded on consumption of the assets

Accrual is seen as providing a much more complete picture of the financial condition of an organization.

The Quality of Information

For good reason, within most governments there is a continuing preoccupation not only with conformity to standards, but to the quality of information.

Even if all principles are followed, faulty and inaccurate financial performance data can greatly distort internal management control. On the external side it can mislead key stakeholders with constitutional rights to be accurately informed. In each case, the credibility of the accounting system and the organization itself comes into question.

The CICA Public Sector Accounting Handbook makes recommendations for assuring the reliability of financial reporting. The Handbook suggests the following qualities should be looked for in financial information: 12

- **Representational faithfulness**: Transactions and events affecting the entity are presented in financial statements in a manner that is in agreement with the actual underlying transaction and events.
- **Completeness**: None of the data necessary to achieve representational faithfulness is missing.
- **Neutrality**: Information is free from bias that would lead users towards making decisions that are influenced by the way the information is measured or presented.
- **Verifiability**: Knowledgeable and independent observers would discern that the information is in agreement with the actual underlying transaction or event with a reasonable degree of precision.

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12 CICA Handbook, Update 18.
The Outputs of Accounting

Governments use the above principles as boundaries or signposts in their attempts to produce a series of documents that paint a picture of financial activity in government.

These documents will conform to an approved Chart of Accounts— which is a document that defines the structure of the financial recording and reporting system of the organization. These reports will consist of: a Balance Sheet, an Income Statement, and a Cashflow Statement.

The Accounting Cycle

The Balance Sheet will show the state of the government’s assets and liabilities. The Income Statement will show how much and where public money was spent. And the Cashflow Statement will show the amount of cash going in and the amount of cash going out during a particular time period.

These documents are prepared according to the Accounting Cycle—which can be thought of as a set of financial steps that a government is expected to carry out during the year. Some of these steps are taken every day. Other bigger steps are taken only at the end of the year. The end result of all of these steps is that the organization then has—in addition to its principles—a procedure for analyzing, recording, classifying, summarizing, and reporting its financial transactions. This process is represented graphically below.
Double Entry Bookkeeping and the Fundamental Accounting Equation

The Accounting Cycle and the creation of financial reports are built upon some very simple concepts:
- double entry bookkeeping and
- the Fundamental Accounting Equation.

From there, a range of reports can be created to meet the organization’s needs.

Doubly entry bookkeeping is based on the recognition that all financial transactions involve an exchange between two accounts. Therefore, in a double-entry system each transaction is recorded in two accounts. Additionally, each account has two columns.

More specifically, when two entries are made for each transaction, one entry is made in the debit column of one account, and the other entry is made in the credit column of another account. The two entries keep the Fundamental Accounting Equation in balance so that:

\[
\text{Assets} = \text{Liabilities} + \text{Equity}
\]

The fundamental accounting equation establishes the rule that: for every action there is an opposite and equal reaction. In more concrete terms, for every increase in the value of one component, there is a decrease in another.

Debits and Credits

It is important to understand that in accounting terms, debit means to or left side and credit means from or right side. Any entry to the left side of an account is a debit and any entry to right side is a credit. Debits increase assets or decrease liabilities or owner’s equity. Credits increase liabilities or decrease assets. The following example and double-entry journal record will illustrate this.

Examples of Debits and Credits Transactions

<table>
<thead>
<tr>
<th>Increase/ Decrease Columns</th>
<th>Assets =</th>
<th>Liabilities +</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit/Credit Definition</td>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
</tr>
<tr>
<td>1. A company mows a yard and receives payment of $50.</td>
<td>50 (cash)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. The same company buys $100 worth of offices supplies and stores</td>
<td>100 (supplies)</td>
<td>100 (accounts payable)</td>
<td></td>
</tr>
</tbody>
</table>
them. The office supply stores give them an invoice that allows them to pay for them in 15 days.

3. The company places an ad in the local newspaper and receives the invoice and pays the bill of $25.

4. The company buys five mowers for $10,000 and finances them with a bank loan.

6. The company receives a cheque for $75 owed from a customer.

<table>
<thead>
<tr>
<th>Event</th>
<th>Debit</th>
<th>Credit</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. The company places an ad in the local newspaper and receives the invoice and pays the bill of $25.</td>
<td></td>
<td>25 (Cash)</td>
<td>25</td>
</tr>
<tr>
<td>4. The company buys five mowers for $10,000 and finances them with a bank loan.</td>
<td>10,000 (equipment)</td>
<td>10,000 (loan payment)</td>
<td></td>
</tr>
<tr>
<td>6. The company receives a cheque for $75 owed from a customer.</td>
<td>75 (cash)</td>
<td>75 (accounts receivable)</td>
<td></td>
</tr>
</tbody>
</table>

**Where are these activities actually recorded?**

The General Journal is a chronological listing of all financial events that affect the organization. The General Ledger is a summary of this information organized according to the types of accounts used in the organization’s financial reports.

The primary rule for journal entries, the individual transactions that make up a general journal, is that they must fully respect the Fundamental Accounting Equation, meaning the recording of the transaction must reflect both its positive and negative elements to permit it to do so, as discussed above.

**Key Definitions of Terms Used In Financial Statements**

**Assets** are resources owned, or in some cases, controlled, by an individual or organization as a result of transaction or events from which future economic benefits are expected to flow to that individual or organizations. They represent the resources of the organization as measured in monetary terms.

**Current assets** are those assets that can be reasonably expected to be consumed within the fiscal year of the organization in order to meet its needs. Therefore, they are available for use and considered part of the resources needed to carry out the activities of the organization within a given period.
Cash is money in any form, either held on hand or on held in financial institutions that is ready for disbursement at any time.

Accounts receivable is money owed to the organization or individual in exchange for goods and services it has provided or for obligations such as taxes, fines and duties. Receivables can take many forms and often reported in ways that reflect those forms. For instance, a municipality may mail out tax forms that, taken together, have a value of $3,780,000. That figure could be reported by the city as an accounts receivable, or, to provide greater clarity, as a tax receivable which is another form of the same thing.

Inventories are materials and supplies held for use in providing services or making a product. Inventories have at least two different meanings:
- Supplies not for sale but for use in the delivery of goods and services, e.g. kitchen utensils for a long-term care home kitchen for meal preparation;
- A detailed list showing quantities, descriptions and values of owned property, e.g. desks, electronic equipment and other items typically found in the fixed asset group needed to carry out the operations of the organization.

Issues of inventory management can be important to many public sector organizations. Some of these, especially surrounding their valuation, will be dealt with later in this text. Some organizations have very large inventories, often with highly cost sensitive items that are of high value.

Prepaid expenses include assets that have been paid for and have not yet been used but that will be used within the fiscal year. These include items such as fire insurance premiums paid in full at the beginning of a year but covering the whole year and rent paid in advance of use.

Marketable securities are, after cash, the most liquid of the assets that appear on a balance sheet. Marketable securities are any form of short-term investment, e.g. stocks, bonds, readily convertible mutual funds, investments or treasury certificates that can be converted to cash.

Fixed assets are those assets that will not be used up or converted to cash within a fiscal year; referred to as long-term assets. These assets include categories such as land, buildings and equipment. In assigning value to fixed assets, it is valuable to go back to the GAAP principle on cost conservatism. Hence, all accounting begins with the cost of the asset not its value at the present time. For example, the purchase of land is recorded at cost. The market value of the land may fluctuate over the years. However, from an accounting perspective this asset is fixed. Therefore, the organization will list the cost of the land at the time of purchase.

The principle of depreciation is that all equipment and plant are used up over a period of time defined by the owners and that, at the end, replacement or refurbishment of
some kind would be necessary. The accrual system plays an important role in recognizing depreciation. Both plant and equipment are used up over their lives, not all at once. Therefore, the value of the asset at a given time from a financial reporting point of view is the original cost minus the depreciation rate that is applied to the particular item. Depreciation therefore will equal the annual use of the item in a monetized fashion. Each year this is recognized in the balance sheet and other reports dealing with equipment.

Depreciation plays a second role – distributing value of the asset to the years it is used, not simply up front when the purchase is made. For example, a department buys a vehicle at a cost of $35,000 to add to an existing fleet. In listing this expense in its journal, the full amount of $35,000 will be reported as reduction in cash. $35,000 will be added to the fixed assets.

However, the department will also make a decision about the usable life of the vehicle, assuming appropriate maintenance is factored in. Let us say that this is 5 years. The department can also assume, based either on experience or on an accounting convention developed within the organization that, at the end of its life, $5000 will be recouped through the sale of the used vehicle. Therefore, to attribute full value from the asset, $30,000 will be distributed over the life of the vehicle. This translated into the following depreciation rate and value assigned at the end of each year to the asset.

**An Example of Depreciation**

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Depreciation</td>
<td>6,000</td>
<td>6,000</td>
<td>6,000</td>
<td>6,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Net Value reported in Balance Sheet</td>
<td>29,000</td>
<td>23,000</td>
<td>17,000</td>
<td>11,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

**Liabilities** are legal financial obligations the organization has to outsiders.

**Current liabilities** are those obligations that will come due in a relatively short period of time, usually within the fiscal year for which the reports are being prepared.

**Accounts Payable** represent the amounts that the organization owes its suppliers, creditors, service agents, etc. This category is highly current, usually requiring payment within one month i.e. staff salaries.

**Long-term liabilities** are obligations that are not required to be met for at least one year or more i.e. mortgages.
**Equity/Net Assets/Fund Balance**

Equity shows the amount of funds obtained from other sources but not needed to discharge liabilities. In the private sector model, equity represents the amount of funds that should be available for shareholders or shareholder wealth. When a company is privately owned, it represents the worth of the company to the owner. For the public sector, equity is represented as net debt or surplus or fund balance.

**Financial Statements – A General Overview**

**The Balance Sheet**

The Balance Sheet reports on the resources controlled by the organization. It is a snapshot of the financial position of the organization. It is inclusive of all resources regardless of how accessible they are for current use.

A typical Balance Sheet for a small organization is shown below. *Hope for Street Kids* – HSK is an organization helping homeless kids through counseling and by liaising with schools and social agencies.

<table>
<thead>
<tr>
<th>Hope for Street Kids</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement of Financial Position</strong></td>
<td>November 30, 2010</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets</strong></td>
<td><strong>Current Liabilities</strong></td>
</tr>
<tr>
<td>Cash</td>
<td>Accounts Payable</td>
</tr>
<tr>
<td></td>
<td>Accounts Payable</td>
</tr>
<tr>
<td></td>
<td>Total Current Liabilities</td>
</tr>
<tr>
<td>Inventory</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>80,000</td>
</tr>
<tr>
<td><strong>Fixed Assets</strong></td>
<td><strong>Long Term Liabilities</strong></td>
</tr>
<tr>
<td>Equipment</td>
<td>Bonds payable</td>
</tr>
<tr>
<td></td>
<td>Mortgage payable</td>
</tr>
<tr>
<td>Building</td>
<td>Total Long-Term Liabilities</td>
</tr>
<tr>
<td>Land</td>
<td>110,000</td>
</tr>
<tr>
<td><strong>Total Fixed Assets</strong></td>
<td><strong>Net Assets</strong></td>
</tr>
<tr>
<td></td>
<td>Restricted Fund (Perm)</td>
</tr>
<tr>
<td></td>
<td>Unrestricted Fund</td>
</tr>
<tr>
<td></td>
<td>Reserve</td>
</tr>
<tr>
<td></td>
<td>Total Net Assets</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>Total Liabilities</strong></td>
</tr>
<tr>
<td></td>
<td>590,000</td>
</tr>
<tr>
<td></td>
<td>590,000</td>
</tr>
</tbody>
</table>
The Income Statement
Unlike, the Balance Sheet, which is a snapshot on a given day, the Income Statement covers the financial transactions of the organization for a given period of time – a month, a quarter, a year. This report set outs the details of the organization’s revenues and expenses for the period.

Organizations may use a number of different ways to group together or categorize their revenues and expenses in the Income Statement:

By Object: salaries, benefits, rentals, cost of services
By Function: e.g., research, client service, inspection, support or administrative services
By Program: operations unit, administration unit, etc.

Income Statement Organized by Object (Plus Year to Year Comparison)
Hope for Street Kids
Income Statement
First Quarter ending November 30, 2005

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government Grants – restricted</td>
<td>17,500</td>
<td>15,000</td>
</tr>
<tr>
<td>Government Grants – general</td>
<td>0</td>
<td>2,000</td>
</tr>
<tr>
<td>Contributions – restricted</td>
<td>4,000</td>
<td>7,500</td>
</tr>
<tr>
<td>Contributions – unrestricted</td>
<td>6,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Fees</td>
<td>0</td>
<td>1,000</td>
</tr>
<tr>
<td>Interest</td>
<td>2,300</td>
<td>2,800</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>29,800</td>
<td>38,300</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries, benefit costs</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Rentals, equipment</td>
<td>2,000</td>
<td>2,200</td>
</tr>
<tr>
<td>Supplies</td>
<td>5,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Aid to Kids: Program Grants, Short-Term</td>
<td>19,000</td>
<td>23,000</td>
</tr>
<tr>
<td>Financial Assistance, Travel Home</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>36,000</td>
<td>41,200</td>
</tr>
<tr>
<td>Increase (Decrease) in Net Assets</td>
<td>(6,200)</td>
<td>(2,900)</td>
</tr>
</tbody>
</table>

The Statement of Cash Flows
Though most public sector organizations use some form of accrual accounting, there is also a need to display changes in cash and cash equivalents resulting from the organization’s activities during the period. Thus, Cash Flows Statement is more narrowly defined, focusing on cash transactions as opposed to such non-cash items as
depreciation. This Statement gives information about the current financial viability of the operation.

Cash flow statements typically report on the following categories of financial information:

**Cash flows from operations:** This will include all cash receipts - taxes, fees, pledges and contribution - and disbursements resulting from the main service delivery activities of the organization.

**Cash flows from investing activities:** This includes cash outflows related to the purchase of capital assets and the purchase of investments and cash received from the disposal of assets of a similar kind.

**Cash flows from financing activities:** This includes cash used to pay for prior financial obligations and the acquisition of debt through bonds, loans, treasury bills, etc.

**Non-cash financing and investing activities:** Certain financing and investing activities do not involve the receipt and use of cash. For example, contributions of capital assets or an investment portfolio to be held for an endowment fund.

**Conclusion**

The simple reality is that you cannot make a good decision without good information presented in an understandable and predictable way. Naturally, this reality applies to financial decisions and financial information. Finding, using, controlling and accounting for government resources demands a reliable and credible financial and management accounting capacity within the organization.

Public sector accounting is the underlying foundation of the management cycle within public organizations. The need to have standards that protect the integrity of the accounting system is great, especially in the public sector where the users’ interests are varied, and credibility is absolutely necessary and always under challenge. Additionally a standard reporting procedure, and common reporting templates increase the legitimacy, transparency, and usefulness of the financial information collected by governments.

When financial information is collected and presented properly, it satisfies the public and empowers managers in the public services. It supports an informed and evidence-based policy process.
Section 8: Accrual Accounting: Providing a Fuller Story

Key Points

When preparing financial statements and budgets, governments are increasingly using an approach to accounting called: Accrual Accounting.

A key attribute of accrual accounting and budgeting is that they provide information that matches costs to the period in which they are incurred.

Therefore, accrual budgeting represents a major challenge to the concept of annualized budgets approved by legislatures, although it in no way reduces the authority of those legislatures. Accrual accounting also forces a better integration of finance, operations and strategic direction because of its inclusive nature.

In this chapter, we will explore:
- the need for accrual accounting,
- the characteristics of cash accounting,
- the characteristics of accrual accounting,
- the differences between accrual and cash accounting, and
- the impact of accrual accounting

Why do we need Accrual Accounting?

There is a strong tendency in government to focus on how much cash is needed in a public sector budget. This has lead to the dependence of the approval of cash expenditures, otherwise known as appropriations. Appropriations are generally made for a one-year period, with some exceptions for capital projects.

With the accrual system, the full costing is better displayed and not restricted to a single year.

The restriction of budgetary approvals to one year at a time can distort or fail to reveal the true overall cost over time of a particular program or purchase. Cash accounting satisfies the annual budget-based interests of legislators and is simple in its presentation, but has a number of serious drawbacks, including:

- *Failure to accurately represent the amount of resource usage*. For instance, a large capital acquisition will distort expenditure upward in the
first year but the usage of that asset will not be recognized in following years.

- Failure to take account of future commitments, guarantees, or other contingent liabilities. A liability will not be recognized until the cash is paid to settle the debt.

- Concentration on cash payments alone, sometimes resulting in an unnoticed deterioration in fixed assets.

Cash Basis Accounting: An Overview

If an organization operates on a cash basis, it recognizes income when it receives it and expenses when they are actually paid.

For example, a government provides a service to one of its client on December 31st, e.g. a license. However, the client does not pay until January 31st. If the government uses cash accounting, it does not count the sale as income until it collects the money -- in this case -- January.

Another Example of Cash Accounting

A new computer system budgeted for $2.5 million is being installed in 2002-3 and 2003-4 fiscal years. The computers are bought on account and $1.75 million will be paid at the beginning of the fiscal year. The balance will be paid at the beginning of the next fiscal year. A cash-based accounting system would display these items this way:

Example of Cash Accounting

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2005-06</th>
<th>2006-07</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Computer System</td>
<td>1,750,000</td>
<td>750,000</td>
</tr>
</tbody>
</table>

Accrual Basis Accounting: An Overview

In accrual accounting, income is recognized when the income is earned, regardless of when payment is received. Expenses are recognized when the liability is incurred.

When an organization using an accrual basis for accounting sells a good, it places the future payment for that good in an accounts receivable as part of its asset base. Similarly, when it obtains goods and takes them into inventory from a supplier, it recognizes two things: it has created a liability in the form of accounts payable, it has
also increased its asset base by adding to its inventory. In this way, the organization has better picture of its actual financial position.

Accrual accounting is the reason for the existence of two major accounts that we have previously examined on the balance sheet. **Accounts Receivable** is the total of all the monies owed to the organization. **Accounts Payable** is the total of all debts owed to suppliers and vendors. For each transaction, a separate record is maintained with detailed information on each customer or vendor. This detail is referred to as the Accounts Receivable and Accounts Payable sub-ledgers. The total of the detail of each sub-ledger must equal to the total on the balance sheet for each of the two major accounts.

**Example of Accrual Accounting**

Taking the same computer system referenced in the previous section, to reflect when the asset would actually be used, it is assumed that it has a five year life cycle. Even though the actual cash outlay is the same as shown in the cash example, the accrual system recognizes the expense when it occurs not when the money is paid. Hence, an accrual financial report would show the costs in the following way:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer System</td>
<td>500,00</td>
<td>500,00</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
</tr>
</tbody>
</table>

Another distinction between the cash and accrual basis is that the accrual system will recognize that assets depreciate over time and will include the depreciation as a non-cash liability in calculating overall financial position.

**The Difference between Cash and Accrual Accounting**

**Comparison of Treatment of Purchase Events under Two Bases of Accounting**

<table>
<thead>
<tr>
<th>Event</th>
<th>Cash</th>
<th>Accrual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article ordered from supplier</td>
<td>No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>Article arrives in Inventory</td>
<td>No effect</td>
<td>Increase accounts payable and Increase Inventory</td>
</tr>
<tr>
<td>Article is used</td>
<td>No effect</td>
<td>Decrease inventory and Decrease fund balance</td>
</tr>
</tbody>
</table>
Article is paid for  Decrease cash  Decrease cash
Decrease fund balance  Decrease accounts payable

**Cash Versus Accrual Treatment of Asset Acquisition and Use**

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Cash</th>
<th>Accrual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset bought but not paid for (on credit or account)</td>
<td>No entry i.e. recognition in accounting system</td>
<td>Asset and liability recognized and recorded</td>
</tr>
<tr>
<td>Asset consumed or used</td>
<td>No entry</td>
<td>Use and decrease in asset value recognized</td>
</tr>
<tr>
<td>Asset purchased on credit is paid for by cash</td>
<td>Decrease in cash and asset recognized</td>
<td>Decrease in liability and cash recognized</td>
</tr>
<tr>
<td>Service delivered</td>
<td>No entry</td>
<td>Revenue and accounts receivable recognized</td>
</tr>
<tr>
<td>Bill sent for service delivered</td>
<td>No entry</td>
<td>No entry</td>
</tr>
<tr>
<td>Bill paid in cash</td>
<td>Cash increased and revenue recognized</td>
<td>Accounts receivable decreased and cash increased.</td>
</tr>
</tbody>
</table>

**Implications of the Accrual Accounting**

As the example below demonstrates, perceptions of financial health can be very dependent on the accounting system used.

In the following example, we can see that, on a cash basis, the government is in surplus. On an accrual basis, it faces a deficit. This deficit does not mean the government needs to immediately raise cash to pay down the deficit. Rather, it means that the full financial resources of the government are displayed so that its full liabilities over time are shown. Therefore, the government is not currently in a position to increase spending as the cash report might suggest.

An example of this is the way in which pension obligations are managed. On a cash accounting basis, the $30 million pension obligation is ignored until the pension payments are actually made, usually years later.

On the other hand, accrual accounting immediately recognizes the obligation. Such recognition has both positive and negative impacts, especially on public organizations. As already noted, it provides a more accurate picture of the full financial obligations of the government in question. It also forces the government to take this obligation into account as it makes policy and program decisions. Such information, especially expenses that will not be discharged for a considerable amount of time and whose value will
change over time, may not be relevant to short-term decision making. They may have the perverse effect of dampening the capacity of a government to meet short-term needs.

An Example of a Week in the Life of One Government

A series of financial events.....
The following examples consider a week in the life of a small government. The effects of the following five transactions are shown in the financial statements below.

- Corporate taxpayers are required to make tax payments of $100 million to the government but only $90 million is received. At the end of the week, $10 million is outstanding.
- The government sells fixed assets for $100 million. The assets had been valued at $100 million.
- Government salary payments are made during the week. In addition to paying employees $60 million, the government is obligated to provide for their pensions when they retire – employees earned $30 million in future pension rights during the period.
- The government settles a long-running legal dispute. It agrees to pay $30 million to the plaintiff in two month’s time.
- All the government’s borrowings are held in foreign exchange. The exchange rate declined by 2% during the week.

---

Financial Reports of the Government

Accrual Accounting

Information

<table>
<thead>
<tr>
<th>Cash Accounting Information</th>
<th>Operating Statement</th>
<th>Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Receipts</strong></td>
<td><strong>Revenues</strong></td>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>a. Taxation 90</td>
<td>a. Taxation 100</td>
<td>Bank 50</td>
</tr>
<tr>
<td>b. Asset Sales 100</td>
<td>s/t 100</td>
<td>Receivables 20</td>
</tr>
<tr>
<td><strong>s/t</strong> 190</td>
<td></td>
<td>a. 10 30</td>
</tr>
<tr>
<td><strong>Payments</strong></td>
<td><strong>Expenses</strong></td>
<td>Fixed Assets 700</td>
</tr>
<tr>
<td>c. Salaries -60</td>
<td>c. Personnel Costs 90</td>
<td>b. -100 600</td>
</tr>
<tr>
<td></td>
<td>e. Foreign Exchange 10</td>
<td></td>
</tr>
<tr>
<td></td>
<td>d. Litigation Expense 30</td>
<td></td>
</tr>
<tr>
<td><strong>Cash Surplus</strong></td>
<td>s/t 130</td>
<td><strong>Liabilities</strong></td>
</tr>
<tr>
<td>130</td>
<td>130</td>
<td>Pension --</td>
</tr>
<tr>
<td></td>
<td>s/t</td>
<td>c. 30 30</td>
</tr>
<tr>
<td><strong>Bank Balance</strong></td>
<td><strong>Net Assets</strong></td>
<td>Liability</td>
</tr>
<tr>
<td>Opening 50</td>
<td>270</td>
<td>Borrowing 500</td>
</tr>
<tr>
<td>Closing 180</td>
<td>-30</td>
<td>e. 10 510</td>
</tr>
<tr>
<td>Accrual Deficit -30</td>
<td>Equity and Reserves 270</td>
<td>-30 240</td>
</tr>
</tbody>
</table>

**Note:** Cash accounting would report a $130 million surplus, while the accrual operating statement shows a $30 million deficit. The $160 million difference arises from the fact that cash accounting:

- ignores the pension liability of $30 million as it is a future cash outlay,
- the asset had a value equal to its sale price of $100 million and this would be reduced from fixed assets inventory.
• the exchange rate change lowered the value of the foreign exchange borrowings by $10 million,
• the judgment created a liability of $30 million which the cash system would only capture in two months time when the payment would be made, and
• outstanding taxes to be received of $10 million remained payable to the government even though they had not been received.

The Pros and Cons of Cash and Accrual Accounting and Budgeting

Some of the advantages of the cash system of accounting and budgeting are that it is:
• simple
• links with cash budget and taxation systems
• easy to understand
• easy to audit and control (within its own parameters of being for a specified period and dealing only with cash requirements)

The risks to a cash approach include:
• the ability to manipulate cash flows over reporting periods (especially from reporting period to reporting period to minimize deficits or over-expenditures)\textsuperscript{14},
• the tendency to spend all available resources within the financial year and, with some exceptions, failure to permit inter-period use of cash funds,
• assets and liabilities ignored, thereby distorting the true financial situation,
• cash statement does not provide a full picture of the financial position especially for short and long term liabilities, as noted, but including depreciation as well,
• no link with economic analyses or organizational outputs.

Accrual accounting is certainly more complex and difficult. It does, however, have the advantage of providing more useful financial information. Some of the other advantages of the accrual basis are:
• accrual accounting is more complete than cash and provide a full balance sheet approach,
• scope for manipulation of cash is removed with an understanding that issues of manipulation are never fully removed from any accounting or budgeting systems,
• facilitates better quality financial management,

\textsuperscript{14} Of course, accrual accounting faces the same problem with the issue recognizing income.
forces full recording of assets and their use, including their depreciation and replacement, something that governments in particular have been remiss in systematically programming into their spending plans,
• provides the opportunity to change organizational behaviour through anticipating ways to either manage future liabilities or fully assess the cost of replacing depreciating assets in a systematic way.
• provides better assessment of financial health and can link more easily with organizational performance data.

The risks associated with accrual accounting are:
• it can be seen as a technocratic exercise and not driven by management needs especially when it is left to the financial experts;
• a lack of adequate accounting standards may mean that the interpretation of the financial information from accrual accounting will have different meanings for different users, standards capable of manipulation;
• there may be a poor linkage to budget information when the budgets are still on a cash basis making the understanding of financial reporting difficult to follow and create the need for ‘cross-over’ reports which can lead to confusion.
• politicians or directors may not impose fiscal discipline, e.g. cost of capital or demand for full cost implications of intergenerational liabilities such as pensions, a matter of leadership or will that no system will rectify or replace;
• management unwilling or unable to use accrual information to improve control of resources, effective oversight or make changes as a result;
• management adopts accrual basis for external requirements but still operates ‘black book’ systems on old basis;\(^{15}\)
• opens the possibility of other forms of manipulations such as seen in the private sector, e.g. the recognition of fictional income;
• Produces reports that are more difficult to understand and use.

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\(^{15}\)Many of the points outlines here were raised by Noel Hepworth in a presentation, “Accrual Accounting in the Public sector” November, 2004, Ankara, Chartered Institute of Accountancy and Public Finance, (UK) but extensively revised by the author.
Conclusions and Overview

Arguments have been made that the introduction of accrual accounting and budgeting system muddy the waters of legislative oversight. The tradition of an annual voting of appropriations, i.e. the actual funds needed to run programs, is inherent in the parliamentary systems of most countries. While there has been strong political support to improve financial information and reporting, the accrual basis does require a political framework that demands a longer-term perspective and understanding of slightly more complex accounting notions than have been used to date.

From a financial management perspective, accrual accounting provides great information. It is a trend that is rapidly becoming the norm in public sector accounting.

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16 Allan Barton, “The Use and Abuse of Accounting in the Public sector Financial Management Reform Process” School of Business and Information Management, Australian National University National Institute of Economics and Business, Public Lecture 4 June 2003,
Section 9: Accountability and Reporting

Key Points

Accountability is a concept with a broad reach, especially for public sector organizations. It straddles the divide between operational process and management and control. It also applies to the internal management and control of public sector organizations in terms of the effectiveness of those controls, the efficiency with which the organization carries out its work and its adherence to the laws and requirements for probity. These elements form the basis of what is called executive accountability, applied to the internal management of organizations.

However, accountability also applies to external authorities such as the legislature and external agencies of review, most notably legislative auditors. Here the accountability is to render an account of ones duties and report to that authority on the execution of the responsibilities that you have received from them. In this context, it also means to be subject to scrutiny, questioning and formal review.

Accountability also extends to relationships with service providers both within the public sector and into the private sector through contracted services, contribution agreements and funding supports. These relationships include some form of reporting or accounting for the funds.

What is Accountability?

“Accountability is the requirement to explain and accept responsibility for carrying out an assigned mandate in light of agreed upon expectations. It is particularly important in situations that involve public trust. However, a commitment to accountability should be though of not only as answering to external audiences, but also as a constructive tool for organization, development, enhancing management practices, self-evaluation and strategic planning”.

“The application of accountability involves three elements:

- Taking into consideration the public trust in the exercise of responsibilities;
- Providing detailed information showing how responsibilities have been carried out and what outcomes have been achieve; and
- Accepting the responsibility for outcomes, including problems created or not corrected by an organization or its officials and staff.”

\[17\] Panel, op. cit, p. 11
What then, are the principal characteristics of accountability relationships in the public sector?

- **Assignment of Authority, Power and Resources**: This is the downward delegation of duties to an individual or organization. This can be by law, by policy, by way of formal delegation matrices or by the completion of an organizational work plan, budget distribution and performance contracts. It can also be implicit or indirect, such as using formal position descriptions to describe duties that have delegations of authority in them and statement of expected duties to perform and, possibly, outcome expectations.

- **Accountability for Performance and Results**: This is the yin and the yan above. In accepting the authority, power and resources, the individual or organization also takes on the responsibility to perform the work and account for the results.

- **Assignment of Duties**: In assigning duties formally, the granting authority also provides clear direction, legislative or regulatory guidance, resources consistent with the expectation.

- **Requirement to Report**: The necessity to report in a formal way, often prescribed by the granting authority deals with three elements:
  - Results achieved
  - Compliance to legal and procedural requirements, and
  - Efficiency.

- **Judgment Exercised**: At some level, be it within the organization and with the public at large, public sector accountability involves the right of the granting authority to make judges about how the accountability has been exercised and act on that judgment. In the ultimate test in a democracy such as ours, that may mean the downfall or re-election of a government. In more mundane terms, it may be clean bill of health on a financial statement by a legislative auditor.

**The Relationship of Accountability and Financial Management**

Financial management, because of it its systematic reporting character, is an important tool of accountability. Financial reports contain information in a prescribed and, at times, legislated, format. They also indicate how the individual or organization has provided good management and stewardship of funds. They can provide information on the results achieved, although only a limited ways.

Good financial management, therefore, can be at the heart of establishing accountability. One of the features of public sector accountability is that it is transient and volatile. Regardless of the adequacy of reporting tools and the confidence in the system, much depends on trust in those providing the information. Having sound financial systems that produce reliable data is a means of establishing such trust.
The Users of Financial and Performance Reports

Public organizations have a number of audiences for whom financial performance reports are prepared. Who uses this information varies broadly.

However, there are a number of interested and engaged parties:

- **Citizens**: The ultimate accountability for governments and for many voluntary organizations is to the citizens they serve. They are, after all, the prime funders of governments. More importantly, they elect the governments.
- **Media**: From time to time, the media will need to look at a statement of financial position or, at least, some of the reports on performance in key areas of their concern.
- **Interest Groups**: Those who represent recipients of services, advocates for particular causes, or those who serve as general watchdog bodies will want to use financial information that the organization provides as a way to understand what is going on, to assess the organization’s effectiveness or determine if their group’s interests were met.
- **Research Bodies**: The Canadian Tax Foundation is a non-profit body which conducts extensive research into the tax system. In doing so, it provides more insight into financial management issues.
- **Legislatures and Board of Directors**: These are the authorizing and legislating bodies that retain ownership of the organizations in legal terms. They set the rules. They have the ultimate accountabilities – to citizens or organization members.
- **External Oversight Bodies**: While we will deal more fully with external auditors and other oversight bodies later on in this Chapter, they play an important role in both serving the legislatures that create as independent reviewers of both financial information, and the maintenance of accounting principles, appropriate financial management practice as well as issues of efficiency and effectiveness.
- **Internal Oversight Bodies**: Similar to the above, organizations will create internal audit and evaluation groups to monitor and assess financial reports.
- **Central Agencies of Government**: Central agencies must take what is termed a ‘whole of government’ view of financial information and performance audits. However, their role in providing this view is dependent upon the quality of the information that is provided by the many departments and agencies of the government.
- **Senior Managers within Agencies and Government**: Financial information and reports are used internally as well as externally. Therefore, there are users within organizations that have a strong interest in both the integrity of the information for monitoring, decision-making and tracking performance.

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18 [http://www.ctf.ca](http://www.ctf.ca)
• **Individual Donors and Funding Organizations**: It is highly unlikely that funding organizations will provide more funding when they lose confidence in the organization’s ability to manage its finances. Similarly, some public organizations may have direct oversight and control roles in relationship to other public organizations. This is most prevalent in the government/voluntary sector interface. Financial reporting and its quality may have an effect on the long-term financial support that is given.

• **Creditors and credit-rating organizations**: Applying to both government and the voluntary sector, one of the first concerns of any lender will be the financial condition of the organizations, be it a town.

### The Objectives of Financial and Performance Reporting

Now that we have looked at who public sector organizations are accountable to, we will look at what they may be accountable for.

Providing reports should, make it possible for the users of this information to:

- assess the discharge of the accountability taken on, and
- make decisions about the public good, the means of delivery, the resources allocated to it and the political consequences of all of this.

To do this, effective public sector financial and performance reporting should meet certain objectives:

- To provide a means to demonstrate the organization’s accountability that enable users to assess that accountability in a manner that is mutually accepted.
- To provide sufficient information to permit users to assess the financial viability of the organization, to assess whether current revenues and expenses will meet program objectives or impose future liabilities on either taxpayers or donors.
- To show that the organization is compliant with its legal financial reporting requirements.
- To show that the organization is compliant with its contractual agreements and/or requirements.
- To provide information needed to evaluate the organization’s operating results for the period under review, including:
  - Sources and uses of financial resources
  - Objectives, standards and obligations and how they were met
  - Changes in financial condition and viability
- To provide information about the organization’s level of service and capacity.
The Role of Audit in the Accountability Process

Effective internal and external audit systems exist to serve the need for public accountability. However, they are not accountability itself. That rests with the individual or organization that has taken on the responsibilities and powers to do something and must account in a public way for it. Audits, in their various forms, are a control tool to be used in both assessing performance and holding those accountable responsible for compliance to both their own objectives and the means approved to achieve them.

At the heart of the use of audit is the need for public and independent assurances on two fronts:

♦ **Attestation** that management’s information is fairly and complete represented, be it financial information (for the most part it is) or any other information that management offers and that it is presented in conformance to practice, standards and rules.

♦ **Assessment** and reporting on management’s performance in comparison to the approved purposes of the program, its stated objectives and goals as well as need for economy and efficiency.

Internal Audit Functions

The management system of an organization in the public sector must be able to demonstrate that it can control its resources. An important tool of exercising that control is having an internal audit capacity.

Some of the functions of an internal audit are:

♦ to review and provide advice on overall control systems of the organization,
♦ to assess project control capacity for large, high risk projects
♦ to ensure that adequate measures are in place to minimize theft or fraud
♦ to ensure that grant and entitlement decision making reduces errors to a minimum to prevent overpayment and the need for recovery
♦ to ensure that regulations covering how funds are spent, recorded and controlled are adhered to
♦ to attest to the accuracy of the information in the financial and reporting system.

The advantage of a good internal audit system is that it enhances control for the organization. It permits the organization to think about its risks, sets up a system for auditing risks suited to its needs, and gets at the errors before external oversight bodies do. These are valuable assets in the control of complex public organizations.
Legislative Auditors

Legislative auditors are appointed, generally through a Cabinet decision, to serve and report on government-wide issues. They are independent of government and report directly to the legislature of the jurisdiction.

From the view of legislators, the value of legislative auditors has not simply been in their technical expertise—it has also been in their ability to conduct audits that may not please those being examined, and to report their findings publicly and independently. They have subjected the operations of the public sector to regular, independent examinations, acting in the public interest, as advocates of transparent government.

Independence

Independence—the state of being impartial and free from bias and conflicts of interest—is the cornerstone of auditing. Anything that impedes an honest and straightforward approach to the performance of an audit will reduce public confidence.

In Canada, legislative auditors have to work at earning the confidence of legislators and the public. The fact that this independence is backed by legislation instills public confidence in the process.

The practices used in the appointment of an Auditor General vary across governments. However, in all cases, the legislature is involved in some way in ensuring their independence. They have assured this independence in a number of ways:

- The legislature usually has some involvement in the appointment of the auditor.
- Appointments are generally for fixed terms, with removal permitted only for cause or incapacity.
- Remuneration of the Legislative Auditor is usually attached to a reference group, to prevent governments from changing pay levels when one too many bad reports come in.
- Legislation provides legislative auditors with immunity from legal action.
- Legislation allows legislative auditors to decide how best to undertake audits (for example, by using in-house staff, contracted staff, or contracted firms).

Reporting to the Legislature

Legislative auditors generally report directly to their authorizing legislatures, at least annually, on anything they think should be brought to the legislators’ attention. The auditors’ reports become a matter of public record and cover a wide range of issues of interest to legislators and the public, including compliance, propriety, the economy, and the efficiency and effectiveness of government operations. Legislative Auditors also
have direct access to each legislature’s Public Accounts Committee. This provides them with a formal means of discussing their reported audit findings with the legislators.

**Third Party Accountability and the Burden of Oversight**

Over the past twenty years and closely associated with the New Public Management\(^{19}\) phenomenon in various countries, contracting of services has increased. Third party delivery by private or non-profit entities has increased in a range of government services. Many governments view this flexibility in delivery as positive. They believe that they can realize savings in buying rather than building service delivery tools. Further, through the integration of ‘back room’ services, i.e. those support functions that generally have no public profile, they can realize the benefits of both centralization and, to some degree, out-sourcing. Finally, these arrangements can allow governments to decentralize and localize service delivery to the public through contracting that matches local circumstances.

However, despite the many benefits, the accountability questions raised through contracting for services and using third parties are many. Some are:

- Do the same standards of accountability that apply to government also apply to non-governmental providers?
- Are reporting requirements the same when the objective of contracting is to focus on results, not process?
- Is the public agency doing the contracting less able to be accountable for financial probity and conformance to rules? Is yes, how does it ensure this takes place?
- Does the public agency managing the contract become a form of auditor as well as a buyer of services?
- Do private or public sector financial standards apply?
- What is the cost and burden especially for voluntary agencies in terms of reporting?

The key contrast with the private sector, and to a certain degree with the voluntary sector is that, while these sectors tend to focus on results of their efforts, government focuses both on results and process. Some of the difficulty that the voluntary sector confronts in dealing with government is that process demands – for reports, conformity with government standards, detailed information needs – overwhelm the results

\(^{19}\) The literature on New Public Management is exhaustive. However, Lester Salamon, *op.cit*, provides a good overview of the most recent developments. Similarly, Peter Aucoin, “the New Public Management: Canada in Comparative Perspective, Montreal, Institute for Research on Public Policy, 1995, is a good early introduction. For a more retrospective look around the world, see THE AGENCY CONCEPT IN NORTH AMERICA: FAILURE, ADAPTATION, AND UNEXPECTED BENEFITS, Andrew Graham and Alasdair Roberts in *Unbundled Government*, edited by Christopher Pollitt and Colin Talbot, Routledge, 2003
intentions of the arrangement. This robs the arrangement of the benefit that is derived from having the voluntary sector involved in the first place.

Excessive demands by government for detailed levels of accountability can both cripple the voluntary organization and render the reason for the arrangement in the first place – creativity, local delivery, unique skill set of the voluntary sector – somewhat useless. They point out the following challenges:

- More detailed review and reporting
- Thinking small and inside the box: project design and accountability are highly risk averse and tend towards process compliance rather than program and results performance
- Delays in approval and renewal processes due to the more onerous contract negotiation and reporting demands of government
- Change in role of government project officer from funder and developer of programming to controller and monitor
- A rush to output and outcome measures to meet compliance needs over longer term perspectives, especially in areas of social service, where much of the voluntary sector’s strength lies.  

Establishing effective contract management to enable good financial administration demands that certain features of the relationship be well structured. Some of these are:

- A clear understanding of the desires outcomes or deliverables
- Clear definitions of accountabilities of all parties involved
- Good costing, not only of the services or goods delivered but also the oversight costs
- Appropriate contract design and contract process administration, including the addition of probity audits in real time for high risk contracting processes
- Clear guidelines on reporting requirements by both parties
- An agreed cash flow arrangement
- Effective contract governance to enable problem solving
- Appropriate post-contract evaluation.

Third party contracting in no way dilutes the accountabilities of public officials for the public good. It complicates that accountability, however. The costs of these new forms of accountability have to be factored into the overall assessment of the use of a third party in service delivery. However, the same has to be said for the cost of effective accountability with the traditional structures of the public sector. Neither is free.

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20 ibid., pp. 458-462
Conclusion

Effective accountability is the touchstone of public sector management in general and financial management specifically. The effective measures that public sector organizations use to report on their performance, explain the actions and provide transparency in both information and processes establish their credibility and enable their political masters to exercise their unique accountabilities within the democratic framework in which these organizations operate. Similarly, within organizations, the establishment of clear lines of responsibility, well-understood objectives, a robust means of measuring and holding individuals and managers to account of the responsibilities that they assume is a measure of the health of the organization.

Unfortunately, in the public sector, exercising effective accountability can be tempered by a highly politicized environment. No measure of effective annual reporting will drive out the taint and damage of a specific incident, be it fraud, misuse of funds or political interference in the use of funds. This atmosphere creates a risk-adverse culture which is incapable of distinguishing between the potentially embarrassing exception and the general rule of good management. In fact, the one negates the other. There is no such thing as a risk free environment. In turn, there is no amount of audit, internal or external, that can prevent individuals from acting illegally. The other truth is that the costs of controls imposed as a result of singly incidents often outweigh the true risk of fraud or misuse of funds.

The challenge remains in the public sector to aggressively deal with fraud and political interference. However, the reaction should be proportional to the action. The response should match the risk.
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