

Only study guide for

**PUB4870**



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## PREFACE

Public management is a dynamic field of study that has to adapt constantly to a range of environmental influences. These environmental influences, which can be related to the open-systems approach, demand that public managers be flexible but at the same time demonstrate accountability towards the clients they serve.

Public institutions have a responsibility towards their clients. This means in essence that public institutions must deliver services and products to the public in order to improve their welfare and general wellbeing. To put it another way, public institutions and the people who work in them are responsible for creating an enabling environment in which the public can prosper.

This module, and indeed whole course, was designed and developed to fulfil a need expressed by public institutions operating at local, provincial and national spheres of government in South Africa. The environment in which public institutions operate has changed, making new qualifications necessary. The qualifications in Public Administration and Management have therefore been re-curriculated.

The re-curriculation of the qualifications in Public Administration and Management made the study of different topics necessary. The aim therefore was to develop a complete course that would cover all the knowledge, skills and competencies that a public manager requires to deliver quality services to the public. Each module is intended as a unique contribution to the field of public management and to provide public managers with the necessary skills and competencies to manage their institutions effectively and efficiently.

*Lecturers*  
*Public Administration and Management*  
*2011*

## HOW TO USE THIS STUDY GUIDE

This study guide has been compiled with the goal of providing learners, who may well ultimately join the management corps of the public sector, with the necessary knowledge, information and sensitivity to deal effectively with a number of issues in South African society. It is intended to serve as a basis and guideline for the application of management functions and processes, as well as a useful source of information for those who simply wish to orient themselves with regard to the environment, functions and processes of the public sector.

The manual includes the following components to guide and support you in achieving your personal and work objectives in mastering the public management functions and processes in the South African public sector.

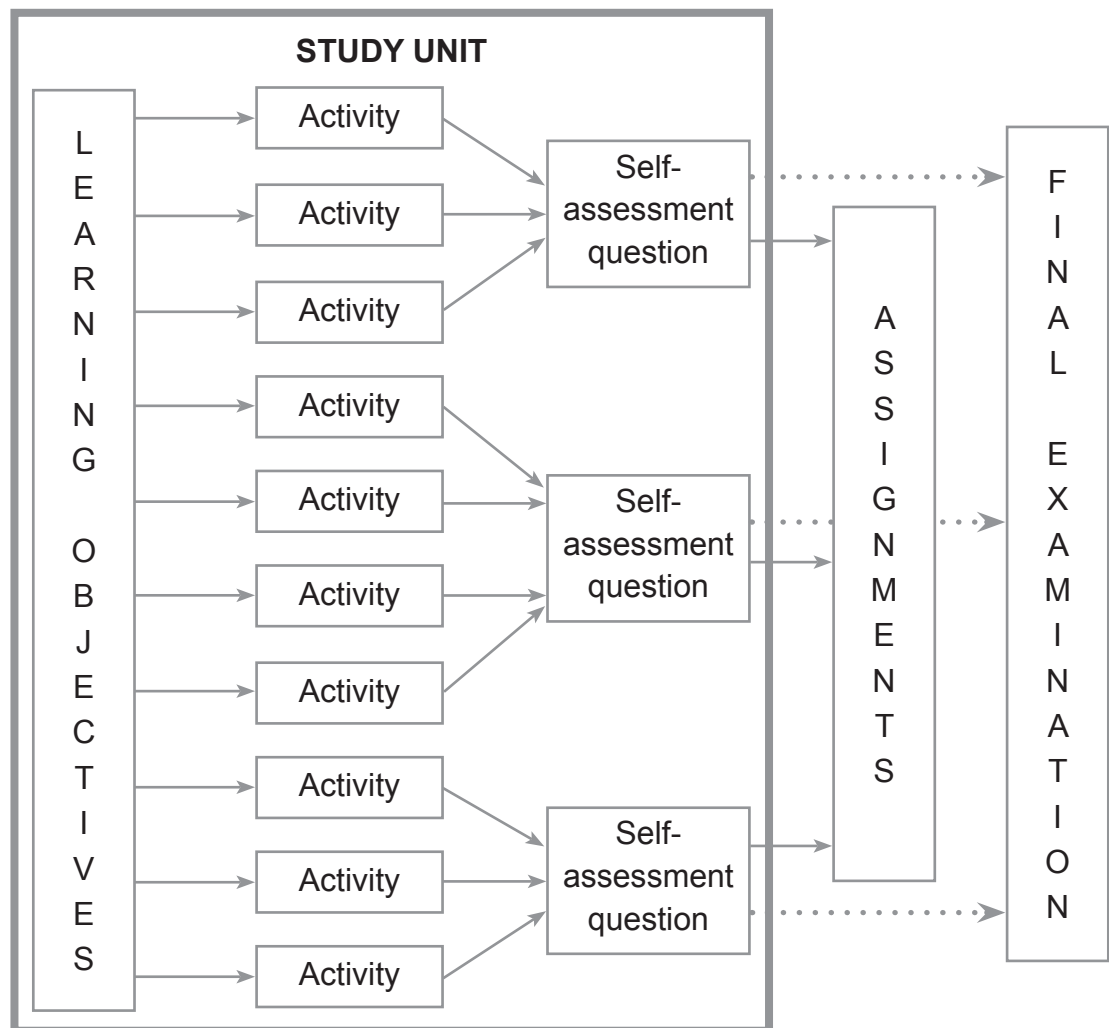
Each study unit in the study guide starts with a **route map** that shows you where you are and how the unit fits in to the module as a whole. The aim of the route map is to provide you with a mental map of the structure of the complete module.

Study units are based on learning outcomes and start with **learning objectives**, in line with the SAQA requirements and complying with the National Qualifications Framework guidelines. These learning objectives tell you what you should be able to do by the end of each unit and during formal assessment.

In the text you will find helpful hints and pointers, as well as **activities** that will help you focus your attention so that you remain objective-oriented with regard to the learning content. These activities should provide you with some of the answers that you will need to complete the **self-assessment questions** at the end of each unit. The self-assessment questions are intended to help you to understand and apply the key aspects of the study unit. **Feedback on the self-assessment questions** is supplied at the end of each study unit. This feedback provides you with pointers and guidance, and will assist study you in assessing your own progress during your studies.

The self-assessment questions form an extensive question bank that is used in other forms of assessment during the course. For example, we use the question bank when we compile your **assignments**. In other words, if you work systematically through all the activities and self-assessment questions in the manual, you should not have any difficulty in answering the assignment questions. The same goes for the final **examinations**. The examinations are set from the self-assessment questions at the end of each study unit and are in line with the learning objectives at the beginning of each study unit.

The diagram below provides you with an overview of how all these components fit together:



## ICONS USED IN THE STUDY GUIDE

The following icons are used in the study guide to help you identify certain types of learning content and study guidelines more easily:



### ACTIVITY

The pencil means that you have to do something, for example answer a question. This will help you to understand the learning content better and should also assist you when you get to the self-assessment questions at the end of each unit.



### DEFINITION

The magnifying glass shows you that an important term or concept has been explained in the text, and that you should study the explanation or definition carefully.



### SELF-ASSESSMENT

This icon indicates the self-assessment questions, which you must answer to test how well you have mastered the learning content.



### EXAMPLE

The pointing finger indicates an area in the learning content where the theory can be related to practice. This should help you to identify your own practical examples that relate to the theory.



### TAKE NOTE

The glasses and sheet of notepaper indicate an important point that you need to study carefully.

# PUBLIC FINANCIAL ACCOUNTABILITY

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# DESIGN, IMPLEMENTATION AND EVALUATION OF INTERNAL CONTROL SYSTEMS IN THE PUBLIC SECTOR

UNIT

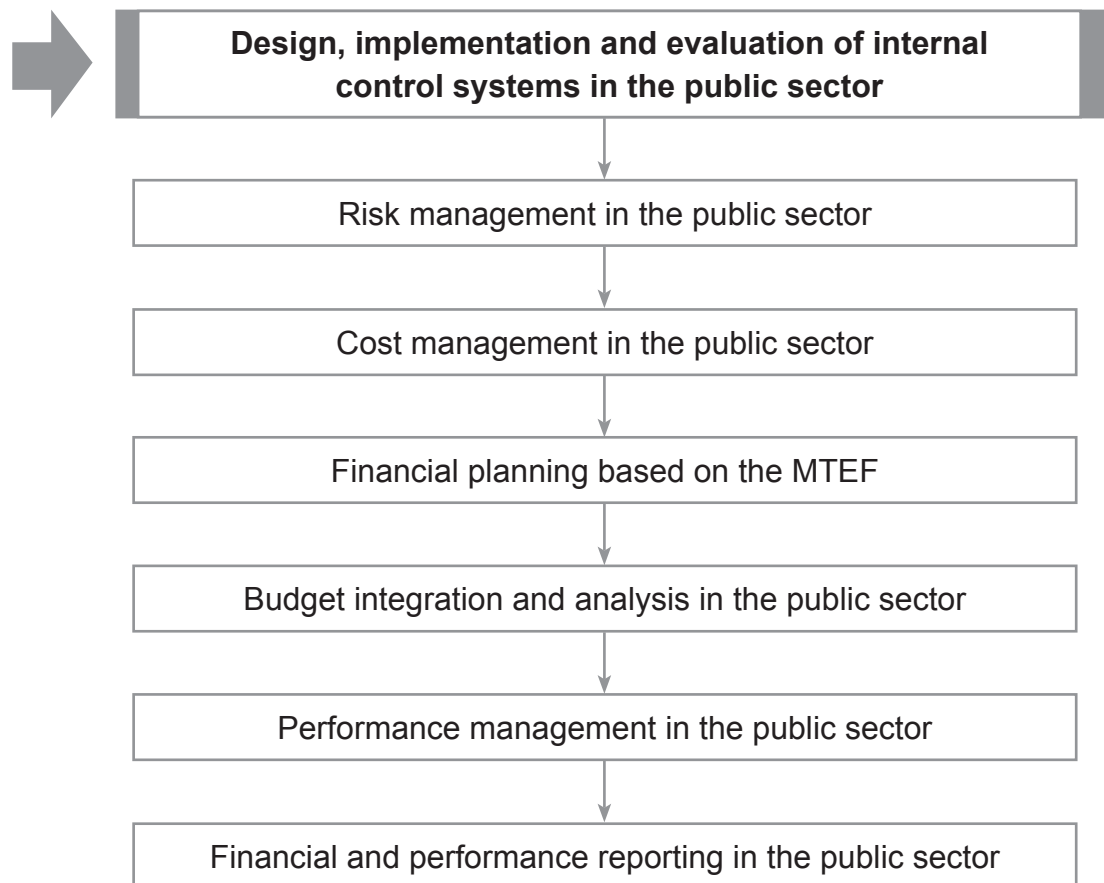
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## ROUTE MAP

Use the route map below to determine where you are within the syllabus and where this study unit fits into the module:



## LEARNING OBJECTIVES

After studying this unit, you should be able to:

- describe the policy framework and requirements for internal control
- describe the internal control system
- describe the internal control process
- describe the design of an internal control system
- describe the implementation, maintenance and monitoring of an internal control system
- describe the evaluation of an internal control system

## 1 INTRODUCTION

Management in public institutions at national, provincial and local spheres of government are mandated to meet specific service standards and fixed output targets. In assisting managers to achieve the set standards and targets, the national government has broadened its supportive role by establishing institutions that will oversee their internal arrangements. The major reason underlying the supportive role of the institutions is to preserve public funds and to ensure that public institutions meet the set objectives within available budgets. In achieving the overall objectives of government, major developments and maintenance of efficient and effective internal control systems are essential.

With the promulgation of legislation, internal control systems, their design and maintenance have become an important focus area of public managers at middle and senior management levels of public institutions. In terms of the legislation, the management of a public institution is required to adhere to certain statutory provisions regarding internal control. The policy framework and requirements for internal control will therefore form the point of departure in this study unit. Before describing the design of an internal control system, we will provide a description of such a system. Then we will discuss the implementation, maintenance, monitoring and evaluation of internal control systems in the public sector to provide an overview of the entire internal control process and system.

## 2 POLICY FRAMEWORK AND REQUIREMENTS FOR INTERNAL CONTROL

The discussion in this section focuses on the policy framework within which internal control must function. The policy framework refers to the statutory requirements that not only guide the development of internal control systems, but the implementation thereof and the basis on which auditing by the Auditor-General is conducted. The discussions consider the most cited policy frameworks for internal control – firstly, the provisions of the Public Finance Management Act of 1999, secondly, the Public Audit Act 25 of 2004 and thirdly, the Treasury Regulations of March 2005.

### 2.1 Public Finance Management Act of 1999

In terms of section 6(2)(e) of the Public Finance Management Act (PFMA) 1 of 1999, “the National Treasury may investigate any system of internal control in any department, public entity or constitutional institution”. This implies that the National Treasury can monitor the effectiveness of the internal control systems of public institutions and can act on suspected non-compliance with other provisions of the PFMA. At the same time, a provincial treasury may also “investigate any system of internal control applied by a provincial department or a provincial public entity” in terms of section 18(2)(f), which has the same implications.

In terms of section 38(1)(a) of the PFMA it is the general responsibility of accounting officers to ensure that their departments have and maintain effective, efficient and transparent systems of internal control as well as systems of internal audit under the control and direction of an audit committee. As far as the accounting officer’s responsibility towards budgetary control is concerned, section 39 of the PFMA stipulates that he/she must ensure that the expenditure of the department is in accordance with the vote and the main divisions within a vote, and the accounting officer should take effective and appropriate steps to prevent unauthorised expenditure and overspending of the vote or a main division of a vote. These provisions imply that accounting officers must exercise control over the budgets of their institutions.

Section 40 of the PFMA stipulates that the accounting officer must, as part of his/her reporting responsibilities, keep full and proper records of the financial affairs of the public institution. These records should assist the accounting officer to prepare the financial statements at the end of the financial year so as to be able to report to the various authorities as required. If an accounting officer wilfully or negligently fails to comply with a requirement of sections 38,

39 or 40, as indicated above, he/she commits an act of financial misconduct. Such misconduct must be dealt with in terms of disciplinary proceedings.

Apart from the accounting officer, there are other officials of a public institution who should be involved in the maintenance of internal controls. These are mainly officials to whom the accounting officer has delegated those powers in writing. In terms of section 45(a) of the PFMA, such officials must also ensure that a system of internal control is implemented within their areas of responsibility. Concerning the powers and duties of these officials, the Act states in section 81(2) that any wilful or negligent failure to exercise delegated powers or perform dedicated duties would constitute an act of financial misconduct. Such an offence has to be dealt with in terms of the disciplinary proceedings that can be instituted against an official.

On the other hand, section 76(4)(b) of the PFMA provides that the National Treasury may make regulations or issue instructions concerning internal control. These regulations will be discussed later. Section 76(4)(d) and (e) of the Act provides that the National Treasury may make regulations or issue instructions concerning audit committees, their appointment and their functioning as well as for internal audit components and their functioning. As far as the audit committees are concerned, section 77 of the Act states how such audit committees should function and indicates the profile of its members.

From the above provisions of the PFMA it should be evident that government is serious about the implementation and maintenance of internal controls in public institutions, to the extent that they have even included provisions in the Act for financial misconduct and criminal offences.

## **2.2 The Public Audit Act 25 of 2004**

In addition to the provisions of the PFMA of 1999, the Public Audit Act 25 of 2004 has assumed a major position in providing guidelines to ensure that public institutions at national, provincial and local spheres of government are compliant to the requirements for internal control measures and systems. In terms of section 3 of the Public Audit Act 2004, the Auditor-General has constitutional and legal status as the supreme audit institution of the Republic of South Africa. In terms of this act, the Auditor-General or his/her delegate has the right to investigate and inquire into any matter, including the efficiency and effectiveness of internal control and management measures relating to the expenditure and revenue of an institution whose accounts are being audited.

In this regard, it is also important to note the provision in the Treasury Regulations of March 2005, issued in terms of the PFMA of 1999, which states that the audit of a committee of a public institution may communicate any concerns it deems necessary to the Auditor-General, among others. This is the reason

why attention will in subsequent sections be devoted to the role of the Auditor-General in internal control and the relationship between internal auditors and external auditors from the Auditor-General's Office.

### **Constitutional functions**

The Public Audit Act tasks the Auditor-General to perform a number of constitutional functions. The Auditor-General in terms of the provisions of the Act must audit and report on the accounts, financial statements and financial management of –

1. all national and provincial state departments and administrations
2. all constitutional institutions
3. the administration of Parliament and of each provincial legislature
4. all municipalities and municipal entities
5. as well as other institutions or accounting entities required by other national or by provincial legislation to be audited by the Auditor-General

Furthermore, in terms of Section 4(3) of the Public Audit Act, the Auditor-General may audit and report on the accounts, financial statements and financial management of –

- any public entity listed in the Public Finance Management Act; and
- any other institution which is funded from the National Revenue Fund or a Provincial Revenue Fund or by a municipality; or authorised in terms of any legislation to receive money for a public purpose.

### **Other functions**

In terms of section 5 of the Public Audit Act, the Auditor-General may, at a fee, and without compromising its role as an independent body perform audit-related services to an institution which is commonly performed by a supreme audit institution. While performing these additional functions, the Auditor-General may –

- cooperate with persons, institutions and/or associations, nationally and internationally
- appoint advisory and other structures outside the administration of the Auditor-General to provide specialised advice to the Auditor-General;
- perform any other function that is necessary to fulfil the role of Auditor-General effectively. The Auditor-General may, in the public interest, report on any matter within the framework of the functions of the Auditor-General and submit such a report to the relevant legislature and to any other organ of state that has a direct interest in such a matter.

## 2.3 Treasury Regulations of March 2005

The Treasury Regulations of March 2005 refers to internal control as a means of achieving corporate management by government institutions. These regulations deal with internal control in terms of audit committees and internal audit, as stipulated in the PFMA and not with internal control as such. From this it can be deduced that government views internal audit and the functions of audit committees as important factors in the maintenance and improvement of internal control systems. One must, however, keep in mind that the Treasury Regulations provide only guidelines which heads of public institutions/accounting officers must follow whilst ensuring effective financial management. The Treasury Regulations of March 2005, issued in terms of the PFMA, are therefore not as prescriptive as the previous Treasury Instructions that were issued in terms of the Exchequer Act 66 of 1975. Internal auditing and audit committees will be discussed later, and the guidelines of the Treasury Regulations will be elaborated on then.



### ACTIVITY

*State the general responsibility of accounting officers to ensure transparency.*

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## 3 DESCRIPTION OF AN INTERNAL CONTROL SYSTEM

Before the discussion of the internal control process, its design, implementation and evaluation, it becomes important to understand the concept and what it involves. The discussions will therefore, first define an internal control system and its components and characteristics, the means to achieve it, the challenges associated with it and the role players involved in it.





### 3.1 Definition of an internal control system

Focus in this section is directed to the definition of the internal control system, from which elements that can be used to describe it are drawn. Four related definitions are highlighted.

The internal control system, as defined by Luyinda, Herselman and Botha (2008:32) includes the *policies, plans and procedures*, and organisational structures designed to provide *reasonable assurance* that *objectives* will be achieved and that undesired events will be prevented or detected and corrected.

Puttick and Van Esch (1998: 162) observes the internal control system as consisting of policies and procedures that are adopted by management to achieve objectives in an orderly and efficient manner. The internal control system includes adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completion of the accounting records and the timely preparation of reliable financial information.

Internal control is defined as a process designed by management and other personnel, to provide reasonable assurance regarding the achievement of effectiveness, efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations.

In order to develop an understanding of a system of internal control, various elements can be drawn from the definitions presented above. These elements – policies, management, reasonable assurance and control objectives – are referred to as the four (4) pillars of an internal control system. The elements/ pillars are the basic assumptions on which all the systems of internal control are designed. The elements/pillars are briefly examined below.

#### (a) Policies

Policies are formalised directives and procedures issued to employees by the management of a public institution that describe in detail how certain activities must be performed. These policies are mainly in the form of a written document or manual and serve as the basis for internal controls. In this regard it is important at this stage that you refer back to your third-year unit on internal control.

#### (b) Management

The management of a public institution should be responsible for designing and implementing internal control systems, although they often delegate this responsibility to a responsible official who must report to them, since they are ultimately accountable for internal control. It is important that you refer to your third-year unit on internal control in this regard.

**(c) Reasonable assurance**

The definition of an internal control system attempts to indicate that there are various factors limiting its effectiveness, and therefore one cannot assume that in the presence of internal controls no fraud or errors can take place. Accordingly, the system of internal control provides only a reasonable assurance of preventing errors, fraud, theft or damage. The inherent limitations on internal control include human error (mistakes), misunderstanding, management override, intentional errors and fraud as well as the cost-benefit aspects of specific internal controls.

**(d) Control objectives**

The description of the system of internal control, as presented above highlights a number of internal control objectives.

These are the objectives that management intends to achieve through implementing an effective internal control system. The objectives are the following:

- to provide reliable information, including financial and accounting information
- to ensure the validity of transactions
- to ensure accurate recording of transactions
- to ensure complete recording of transactions
- to safeguard assets belonging to the institution
- to promote efficiency and effectiveness
- to encourage adherence to internal policies and directives
- to ensure compliance with regulations

**ACTIVITY**

*Try to formulate your own understanding of an internal control system.*

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### **3.2 Components of the internal control system**

According to the American Institute of Certified Public Accountants (AICPA, 2004) Amudo and Inanga (2009:128), internal control consists of the following five interrelated components: the control environment; risk assessment; control activities; information and communications; and monitoring. A brief description of each component is dealt with in subsequent sections:

#### **(a) Control environment**

The control environment includes integrity, ethical values and competency of people in the public institution, management's philosophy and operating style, the way management assigns authority and responsibility, organises and develop its employees as well as the attention and direction provided by management. The control environment is the foundation for all other components of internal control that provides discipline and structure.

#### **(b) Risk assessment**

Risk management includes the identification and analysis of risks to achieve the institution's objectives and forms the basis to determine how risks should be managed. This component ensures that internal and external risks are addressed. However, before conducting a risk assessment, objectives must be set and linked at different levels of a public institution.

#### **(c) Control activities**

Control activities refer to policies and procedures that ensure that management directives are carried out. Control activities occur throughout the organisation, at all levels and in all functions. These include activities like approvals, authorisations, verifications, reconciliations, reviews of operating performance, security of assets and separation of duties.

#### **(d) Information and communication**

Information and communication concerns the need in the public institution to identify, capture and communicate information to the correct employees to enable them to carry out their responsibilities effectively. Information systems within an institution are important to this element of internal control. Internal information and external events, activities and conditions must be communicated to enable management to make informed decisions.

#### **(e) Monitoring**

The internal control system requires to be monitored continually by management and other employees in a public institution. Monitoring

activities are required to ensure that serious internal control deficiencies are reported and rectified.

### 3.3 Combination of control procedures

The internal control environment is an essential component of an internal control system, since it provides a climate that is conducive to effective internal control procedures, (DSE 1998:54). In the application of internal control procedures, errors or irregularities are prevented not by any single control functioning in isolation, but by a number of controls operating in combination to produce a system of internal control. When review procedures are performed on a specific group of transactions, it is important that the principle of the segregation of duties be applied and proper documentation be maintained.



#### ACTIVITY

*List the components of an internal control system.*

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### 3.4 Characteristics of an effective internal control system

An internal control system should display certain characteristics that indicate its effectiveness. Thirteen characteristics have been identified for discussion in this unit and include the following:

#### (a) Timeliness and proactive

The internal control system should prevent errors or irregularities from happening rather than just detecting them once they have occurred (DSE 1998:54). If the errors or irregularities cannot be prevented, the system should be able to detect and correct them in good time to limit costly exposure. Information must therefore be gathered, processed and evaluated quickly to ensure that timely corrective actions can be taken.

#### (b) Economy

The internal control system should operate in such a way that the benefits outweigh the cost of implementing it (DSE 1998:54). To keep costs to a

minimum, the least possible control needed to achieve the desired results should be applied (Crous 1990:490). This is referred to as the economic principle, which means the least input for the most output (DSE 1997:31). Internal controls should reduce potential losses and expenses.

**(c) Accountability**

The internal control system should be devised to assist employees in demonstrating their willingness to carry out the tasks and responsibilities assigned to them.

**(d) Placement of controls**

The internal control system should make provision for the positioning of internal controls where they are most effective (Sawyer & Dittenhofer 1996:99). They should therefore be installed, among other reasons,

- where performance can be measured
- where corrective action is easier to take
- where time is available for corrective action

**(e) Flexibility of controls**

The chosen internal control system has to be flexible enough to allow for any change and to exploit new opportunities (Crous 1990:489). The system should be able to function irrespective of the person who performs the task, the type of accounting system in operation or other factors affecting the environment, such as a change in management, the extent of the operations or an increase in the number of transactions (DSE 1998:55).

**(f) Cause identification and corrective action**

Corrective action can only be applied after the cause of the problem has been identified. Therefore, the internal control system must assist managers with both identifying problems and rectifying them.

**(g) Appropriateness and strategic focus of controls**

The internal control system should be designed to complement the management style, size of the public institution and level of expertise of the employees (DSE 1998:55). The system should support the objectives of management (DSE 1997:32). Managers cannot control everything, and it is therefore important that a system of internal control focus on strategic control points. In fact, the most efficient and useful controls are those that work on an exception basis, responding only to significant deviations.

**(h) Accuracy**

It is important that internal control systems produce correct and accurate information to ensure that proper and appropriate corrective action can be taken. Without an accurate internal control system, reliable and relevant information will not be available to enable informed decisions to be taken.

**(i) Integration of planning and controlling**

If an internal control system is not integrated with the planning process and if the standards implemented are not related to the objectives of management, control will be ineffective. It is therefore important that the system is integrated with planning processes in a public institution and that it helps in achieving the internal control objectives.

**(j) Adaptability of the system**

The internal control system should utilise various control techniques or stages of control, depending on the different situations and processes that prevail at given times. Different control techniques or procedures should therefore be used during the pre-control, steering control or post-control stages.

**(k) Comprehensibility**

The internal control system has to be clear, logical and understandable. Internal control systems that are difficult to understand lead to avoidance of control, frustrated workers and unnecessary errors. Managers and employees involved in the internal control system must therefore be able to understand it; otherwise the value of such a system will be questionable.

**(l) Acceptability**

The internal control system should be understandable to contribute to improving individual and institutional performance. It should also stimulate increased productivity and growth as well as greater independence and responsibility among management and subordinates. This means that employees have to accept the internal control system as useful and helpful to the public institution.

**(m) Objectivity**

The internal control system has to be objective, not subjective. It should be the main aim of any designer of internal control systems to ensure that an internal control system is objective. Although objective standards are important, managers and employees should look beyond quantifying them.



### ACTIVITY

*List the characteristics of an effective internal control system.*

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## 3.5 Means of achieving internal controls

The word 'means' is hereby used to simply refer to methods or possible ways with which the objectives of an internal control system can be achieved. This refers to possible operational ways by which managers can achieve internal control in a public institution. For each of these means of internal control, certain criteria should be determined that management and internal auditors can use to evaluate the adequacy and effectiveness of the internal control system.

### (a) Organisational structure

An organisational structure is a successful way or method of achieving internal control. The organisational structure of a public institution is an approved, intentional structuring of roles assigned to people in the institution to ensure that it can achieve its objectives efficiently. An organisational structure indicates and demonstrates the accountability levels and hierarchies within a public institution as well as the reporting lines. The organisational structure increases the likelihood that if one employee makes an error, another employee will discover it. The organisational structure reduces the risk that employees would perpetrate and or hide errors in their performance of duties.

### (b) Policies

Public institutions should have policies in place in the form of legislation, regulations or directives, general or specific, that guide the execution of instructions, delegations, activities and functions. Without these policies, public managers and officials will not be able fulfil their responsibilities and tasks, since the policies serve as guidelines for service delivery.

**(c) Procedures**

Procedures are means employed to carry out activities in conformity with prescribed policies. As such, procedures are implemented to reduce the possibility of fraud and error and to ease the workload. Therefore, procedures are normally detailed in a manual that explains step by step the work that must be done.

**(d) Employees**

Employees make an internal control system work. The responsibility for good internal control rests with employees. Employees should be hired or assigned according to their skills, competencies, experience and qualifications to do certain jobs. The best form of control over the performance of these appointed employees is supervision. All employees in a public institution play an important role in achieving the objectives of an internal control system.

**(e) Accounting**

Accounting is the indispensable means of financial control over activities and resources. It provides an organised framework for transactions and is the backbone of a public institution's operational activities. The accounting system of a public institution forms part of the internal control system, since it produces the financial statements that must be included in management reports.

**(f) Budgeting**

The budgets are forms of the internal control system that give indication of where the institution's money will be used. Budgets are statements of expected results expressed in numerical terms. As a control, the budget sets a standard for input of resources and provides an indication of what should be achieved as outputs and outcomes.

**(g) Reporting**

As in most organisations, the functions and decisions of managers of public institutions are based on the reports they receive. Reports should therefore be timely, accurate, meaningful and economical, addressing the real issues in an institution.

**3.6 Possible challenges of an internal control system**

Countries implement regulations that assist managers in public institutions to document and assess internal control systems' challenges and successes. Although an internal control system has benefits, it is often faced with challenges.



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According to Sawyer and Dittenhofer (1996:100–101), seven challenges of an internal control system can be identified.

**(a) Cost of control**

Implementing an internal control system is costly since it involves activities such as hiring of employees who will implement it, and external auditors to perform the auditing function. The costs that are involved in implementing the internal control system often make it impossible for under-resourced organisations to afford it.

**(b) Excessive, redundant and obsolete controls**

Excessive or redundant internal control systems in public institutions may cause confusion and frustration among employees and the consequent non-application of the system. The internal control system should therefore be monitored for continued relevance to ensure that it responds to a specific need and does not become counterproductive.

**(c) Provision of information**

The information that an internal control system provides may not be understood or could be transmitted to the wrong person. In certain cases the information is so detailed as to be useless. Managers should therefore ensure that the correct information is communicated to the correct employees to ensure that the system functions effectively.

**(d) Increased controls**

As control activities increase, they reach a point where their effectiveness may actually decrease. They may therefore cost more than the exposure that they are designed to guard against.

**(e) Overemphasis on controls**

Overemphasis on an internal control system can make the system an end rather than a means towards the end. People may therefore work to satisfy procedural controls and lose sight of the operational objectives that must be met. The result may be mental rigidity and reduced flexibility. Controls can also create slavish adherence to procedures at the expense of reason and common sense.

**(f) Resistance to controls**

People generally resist control, especially if they have not been involved in developing the control system or do not understand the objectives

that must be met by the system. Controls perceived as unreasonable can actually stifle creativity and initiative. Except for those cases where controls become a basis for rewards and punishment, controls may take on undue importance in the eyes of those affected.

#### (g) Influence of behavioural aspects

The behaviour of employees must be taken into account when internal control systems are designed and enforced. This can be done by communicating with employees or involving affected employees in the design of the system. People accept control willingly when they understand what will be achieved by applying the control activities. Several internal control systems have failed in the past because behavioural aspects were not taken into account.



#### ACTIVITY

*List the means, ways or methods by which internal control can be achieved.*

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### 3.7 Role players in internal control

A number of role players are involved in ensuring that appropriate internal control and an internal control system operate properly within a public institution. They include managers, other employees, the internal control section, the internal audit unit, audit committees, external auditors as well as the national and/or provincial treasuries.

#### (a) Management

Managers, as indicated in the definition of an internal control system, are held responsible for implementing a system of internal control and for safeguarding the resources of a public institution. Managers of public institutions have the responsibility for implementing strategies and policies in the workplace. They have to identify, measure, monitor and control risks incurred by the public institution, and are also expected to maintain an organisational structure that assigns responsibility to ensure that delegated responsibilities are effectively carried out.

They have to set appropriate internal control policies and monitor the adequacy and effectiveness of the internal control system.

**(b) Other responsible employees**

Although it is primarily the responsibility of management to ensure the proper functioning of the internal control system of a public institution, every employee that performs certain procedures, instructions or directives must also contribute to its functioning by adhering to the controls that are in place. Those employees to whom responsibilities have been delegated to by management should ensure that the internal control system operates effectively.

**(c) Internal control section**

For an effective internal control system, public institutions should make provision for an internal control section. The internal control section operates within each financial division, and its main functions are the following:

- to verify the correctness of financial data entry forms and transactions by checking that the forms have been filed in accordance with the prescribed procedures
- to verify that all transactions were authorised by an official delegated to do so
- to verify whether the expenditure and income are correctly reflected in the financial records of the public institution
- to determine whether the various sections and offices that generate payments and collect income follow the correct procedures and instructions.
- to assist the internal audit section and the Office of the Auditor-General, since they cannot check every transaction for correctness (The internal control section does the daily checking of transactions, which is known as continuous checking, whereas auditors do periodic checking.)

**(d) Internal audit function**

The internal audit function plays an important role in ensuring effective internal control in public institutions. Each public institution, in terms of the provisions of the Treasury Regulations of March 2005, must have an internal audit function. The treasury may direct that public institutions share an internal audit function, and if such arrangement is entered into, the Auditor-General must be informed within 30 days of the arrangement. In other cases, an internal audit function may be partly or completely

contracted to an external organisation with specialist audit expertise, provided that its selection is in accordance with government's competitive tendering procedures.

The purpose, authority and responsibility of an internal audit function must, in consultation with the audit committee, be formally defined in the audit charter and be consistent with the Institute of Internal Auditors (IIA) definition of internal auditing. Among other activities, an internal audit function must prepare, in consultation with and for approval by the audit committee –

1. a three-year strategic audit plan and its risk management strategy
2. an annual internal audit plan
3. plans and quarterly reports that are indicative of its performance to allow effective monitoring and possible corrective interventions.

The internal audit function must co-ordinate with other internal and external service providers of assurance to minimise duplication of activities. Furthermore, it must assist the accounting officer or top management in maintaining efficient and effective internal control in a public institution.

**(e) Audit committees**

In terms of the Treasury Regulations of March 2005 and sections 76(4)(d) and 77 of the PFMA, internal audit committees perform a monitoring and advisory function to support the accounting officer in a public institution. Unlike in the case of internal control sections or units in public institutions, the audit committees are constituted so as to ensure that they are independent and operate in terms of written terms of reference. They are not associated with any other section of a public institution and perform an independent function. The terms of reference entered into between the accounting officer of a public institution and the audit committee must explain its membership, authority and responsibility. The audit committee are held responsible for reporting and making recommendations to the accounting officer of public institution.

**(f) External auditors (Auditor-General)**

In terms of the Public Audit Act 25 of 2004, the Auditor-General as an institution or person contemplated in section 181(1)(e) of the Constitution of the Republic of South Africa 1996 plays an important role in ensuring efficient and effective internal control systems in public institutions. The Office of the Auditor-General is the external auditor for all public institutions at national and international spheres and for institutions that are funded from public funds. In terms of the Public Audit Act 25 of 2004, the Office

of the Auditor-General is an independent institution that reports its findings to that national Parliament or Provincial legislature. The main functions of the Auditor-General are to conduct regularity and performance audits in public institutions.

**(g) National Treasury or provincial treasuries**

The National Treasury and the nine provincial treasuries established in each province of the Republic of South Africa are important role players in ensuring that public institutions in their operational areas of jurisdiction comply with internal control regulatory frameworks. In terms of sections 6(2) and 18(2)(f) of the PFMA 1999, the National and Provincial Treasuries have the powers to investigate any financial management or integrity of the internal control system in public institutions. Both the treasuries also have the authority to intervene where deemed necessary to ensure that internal control systems function optimally.



**ACTIVITY**

*List the role players that are involved in the functioning of an internal control system.*

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## 4 INTERNAL CONTROL PROCESS

As noted in its definition, internal control is not an event, but a series of actions and activities that occur throughout a public institution's operations on an ongoing basis. The discussions in this section provides an overview and summary of the control process by considering the various steps that constitute an internal control process. The control process can be conveniently reviewed in terms of the following eight key steps:

**(a) Development of objectives**

The first step in the process is to determine, as part of a strategic management planning exercise, the objectives that the institution must achieve. These objectives might include the areas that management intend to look into during a specific period of time and should be seen in the context of the objectives that the internal control system has to provide a solution to.

**(b) Set standards**

The second step entails setting standards. This step entails that after the objectives of an institution have been determined, quantifiable standards must be set during the planning process. The standards can be used as criteria for assessing the achievement of the objectives.

**(c) Measurement of actual performance**

The third step of the control process entails the measurement of the actual performance. This step requires that once the standards have been set, the internal controls can be implemented. To establish whether progress is being made towards achieving institutional objectives, the control process must provide measures of current performance in relation to the set standards.

**(d) Comparison of actual performance with standards and objectives**

During the fourth step, the institution's actual performance of activities must be compared with the set standards. This step makes the identification of differences or performance gaps possible. This comparison may be for both current time periods and longer cumulative periods. Although the comparison is a specific step in the control process, it is in practice often combined with the reporting of actual results and performance.

**(e) Analysis of the cause of deviations**

The fifth step in the control process is to determine causes of the reported differences or performance gaps. In essence this involves identifying the various causal factors and attempting to measure the impact of each. This entails collecting information about the various operational activities, trying to determine both the immediate as well as basic causes, and evaluating the importance of individual causes of deviations. It may sometimes happen that the actual performance, measured against the set standards, does not indicate any deviations and therefore does not require any corrective action.

**(f) Determination of appropriate managerial action**

The analysis of the causes of differences inevitably blends to some extent with the determination of appropriate managerial action. In most cases the responsible manager, assisted by the internal auditor, will make recommendations for management action. It is important that the available alternatives be evaluated and a decision be made on specific action to be taken.

**(g) Taking action**

During this step the decision on action to be taken to correct the deviation from the set standard must be implemented. The instructions issued must give due regard to the required urgency, the level of the personnel being dealt with and the complexity of the actions that must be taken. The corrective action to be taken can sometimes be accomplished very quickly, such as correcting an error, or it may extend over a long period, such as modifying a complex system. In all these cases, however, there should be follow-up or feedback to satisfy the responsible manager that the action has been taken as requested. Sometimes the proper action may be to do nothing at all, especially if there is knowledge of future developments that will adequately correct the current deviations. It may also happen that the cost of corrective action outweighs the risk, which makes it unfeasible to implement the corrective actions. It must, however, be recognised that taking no action is itself a decision and therefore a kind of responsive action.

**(h) Continuous reappraisal**

The final step in the control process is the appraisal of the results. This is in effect a means to check the effectiveness of the action taken earlier in step 7 and of the manner in which the actions have been taken. This final step provides the necessary linkage of the original control cycle to the next cycle. Continuous appraisal blends with the next analysis of the measurement of progress and determination of further managerial action. Post-appraisal is a continuing action reflecting the input of changing conditions, experience and knowledge of the control environment.



### ACTIVITY

*List and briefly describe the steps of an internal control process.*

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## 5 DESIGN OF AN INTERNAL CONTROL SYSTEM

The design of an internal control system is influenced by specific objectives that management strives to achieve. The design of an internal control system focuses on selecting particular operational aspects to be controlled, determining the extent to which they must be controlled, and choosing the way in which control actions will be carried out (Atkisson et al 1986:96). The design effort takes into consideration the implementation of the internal control system, but also tends to focus on what management needs to achieve. The design of an internal control system should be directed by cost-benefit considerations. In other words, the consequences of not having internal controls should be weighed against the cost of establishing and implementing various configurations of controls. It is therefore important that internal controls be implemented to the extent that they are cost-justifiable.

A logical approach to the design of an internal control system is to determine the various risks that exist in a public institution and to develop the internal control system around them (Puttick & Van Esch 1998:164–165). Policies should be established and control procedures introduced to ensure that avoidable risks are limited to those that management has decided to assume. In the design of an internal control system, the following factors should be taken into consideration:

- The degree of involvement of management
- The integrity and efficiency of the personnel operating the system
- The cost-benefit decisions when considering the design of the system



The approach adopted for the design of internal control systems, e.g. from an accounting perspective, should focus on transactions rather than on the functions of organisational units. By focusing on transactions a number of interdepartmental lines are crossed, which makes the design of an internal control system generally applicable, as it removes the uniqueness of specialised sections. This approach has the advantage of being appropriate irrespective of the method of processing the data (whether manually or by computer). Since the activities of different organisational units have a lot in common, similar transactions can be grouped into “transaction cycles”. By focusing attention on each type of transaction, it can be established whether the desired control is present, as the transaction flows through the system crossing different lines of authority. In the design of an internal control system, the establishment of control objectives must also receive considerable attention as well as the various control procedures that have to be followed.

### **5.1 Identification and assessment of potential risks**

Management’s first step in the design of an internal control system is to identify the specific risks that face a public institution, programme, activity or project (Gauthier 1996:43). Management can use these five implicit assertions as a practical tool to draw up a list of potential risks that must be avoided. The five assertions for identifying significant risks can be summarised as follows:

- that all the assets and liabilities included in the internal control audit report actually exist and all the transactions and events have really occurred (existence or occurrence)
- that the reports contain all relevant facts (completeness)
- that all the assets and liabilities included in the report are truly assets and liabilities of the public institution (rights and obligations)
- that all items have been properly classified, that all transactions and events reported took place within the accounting period, and that all assets and liabilities were present as of the last day of the financial year (allocation)
- that the display and disclosure in external financial reports conform to the requirements of generally accepted accounting principles (presentation and disclosure)

The design of an internal control system should be driven by risk assessments. Wherever risk exposure exists, for example, potential loss of assets or mis-statements of accounting or management information, controls should be established to limit that risk. The greater the risk, the more extensive the internal control that is warranted. Risk encompasses the total monetary value of the assets that are exposed to loss as well as the probability of such loss occurring.

## 5.2 Identification and selection of compensating controls

Having drawn up a list of potential risks, management should turn attention to developing control-related policies and procedures that can compensate for such risks (Gauthier 1996:44–45). Control-related policies and procedures can be classified into the following eight categories:

- prior authorisation and approval
- properly designed records
- security of assets and records
- segregation of incompatible duties
- periodic reconciliations
- periodic verifications
- analytical review
- timely preparation of financial reports in conformity with generally recognised accounting practice (GRAP or GAAP)

Management should carefully examine its documentation of how transactions and events are processed to see which of these control-related policies and procedures are in place and which still requires to be designed. Once the control-related policies and procedures have been identified and developed, it is necessary to determine whether there will be enough appropriate compensating controls in place to counteract or contain each identified risk.

Controls should be designed to ensure that every transaction is documented, that invalid transactions are not put on the system and that all valid transactions are recorded accurately. The type of controls selected will depend largely on the quantity and nature of the transactions. Every general control can be viewed as having specific related controls that actually establish and monitor internal control. A system designer therefore needs to consider potential risk, stated risk and actual risk exposure when deciding which specific controls are warranted. Without certain general controls, some specific controls become useless.

## 5.3 Identification of key performance areas

The third step in the design of an internal control system entails the identification of key performance areas (KPA's). Public managers must identify their key performance areas before internal control systems can be developed (Crous 1990:487). As service delivery becomes more complex and comprehensive, centralised decisionmaking and control become more difficult. Key performance areas are those responsibilities of the individual public manager or individual employees within the public institution that must be carried out efficiently to ensure results and success. Typical examples of KPA's in a public institution are service delivery activities, cash management activities and relations between management and subordinates. One can distinguish between general KPA's as well as unique

KPAs. General KPAs include those activities for which the specific public manager is solely responsible. Unique KPAs refer to the manager's responsibility to see to it that subordinates perform their individual responsibilities satisfactorily.

## 5.4 Identification of strategic control points

Apart from the key performance areas, critical or strategic control points must be identified, to ensure that the monitoring and gathering of information for control purposes can take place efficiently and effectively (Crous 1990:487– 488). A control point is a point in a process where an error or irregularity is likely to occur, creating a need for control. Strategic control points have the following three basic characteristics according to which they can be identified:

- They are control points for key activities.
- They must be selected carefully according to time requirements, to ensure that activities can be stopped or modified before serious deviations occur.
- A healthy balance between quantifiable and non-quantifiable strategic control points is essential. Unbalanced strategic control points are reflected in an excessive tendency to control quantifiable activities such as service delivery and cash management, while non-quantifiable activities such as external relations and personnel development are exposed to hardly any control at all.

Every public manager must develop a control system to satisfy the particular requirement, because no blueprint for the identification of strategic control points exists.

## 5.5 Establishment of standards and norms

According to Crous (1990:488), seven types of standards serve as norms against which the actual or expected performance can be evaluated. A brief discussion of each standard is presented below:

### (a) Physical standards

Physical standards imply non-monetary standards and occur at the operational level where material, labour products and service delivery are relevant. Physical standards are usually expressed in quantifiable terms, for example, production units per person-hour.

### (b) Cost standards

Cost standards are generally used at operational level and are expressed in monetary units (terms). They consist of aspects such as labour costs per unit, direct and indirect production costs per unit as well as material costs per unit.

**(c) Capital standards**

Capital standards refer to invested capital rather than operational costs. Capital standards are related to the balance sheet and not to the income statement. Capital standards include aspects such as return on investment.

**(d) Income standards**

Typical income standards include, for example, average payment per taxpayer or per capita sales per client.

**(e) Programme standards**

Programme standards can be developed and used for a programme to improve service delivery. Although the evaluation of programme performance includes a subjective element, specific factors such as time allotment can be used as an objective standard.

**(f) Intangible standards**

Intangible standards are difficult to determine, because neither physical nor monetary measures can be used. However, with intangible standards, tests and assignments that can be used effectively to determine the needs, drives, desires, attitudes and values of individuals are developed.

**(g) Verifiable objectives**

Currently the value of intangible standards is disappearing because there is a tendency to develop a whole network of verifiable qualitative and quantitative objectives for the different managerial levels. Performance objectives can be formulated through thorough research and constructive thinking and can serve as performance standards.

**5.6 Guidelines for the development of an effective control system**

According to Crous (1990:492–493), there are several guidelines that can be followed when designing an effective internal control system. Guidelines are tools that can be used to ensure that the designer takes certain aspects into consideration when designing an internal control system. It is therefore important to elaborate on these guidelines:

**(a) Simplicity**

Simplicity is key in the design of an internal control system. This does not mean that only activities that are easily measurable and can be easily evaluated must be attended to. The internal control system must be

understood by everyone to prevent a lack of involvement, uncertainty and ultimate frustration.

**(b) Participation**

Managers must ensure that employees at various levels of an organisation participate in the development of internal control systems. When employees are involved in the development of standards and in the development of the internal control system, there is seldom any resistance to the implemented system. Control systems and standards developed in such a manner are often more realistic.

**(c) Management by objectives**

Management by objectives offers many advantages for internal control. Through participating in objective formulation and the development of standards, participants usually know beforehand what the reward will be if objectives and standards are achieved. This will have the result that management by objectives serves two purposes, namely motivation and the integration of planning and controlling.

**(d) Reaction to available information**

When the internal control system is developed, it is important to ensure that it will provide the necessary relevant information in a timely manner. This will allow public managers to react quickly to the latest information that is made available by taking appropriate action to correct deviations from the set standards.

**(e) Control not used as punishment**

If the controls built into an internal control system are intended to be used by public managers as a means of punishment, the system will never assist management to achieve its objectives. An internal control system should therefore be designed in such a manner that the controls will motivate employees to use it optimally.

**(f) Control designed for specific situations**

Internal control systems are designed mainly to establish order and continuity and to achieve desired results. The internal control system should therefore suit the public institution and be adapted to the particular situation.

**(g) Control must emphasise self-adaptation**

The system must be developed in such a manner that management should be responsible for adaptations to the system only if employees do not have sufficient information or authority to bring about adaptations themselves.

Apart from the seven guidelines above, the thirteen characteristics of an internal control system dealt with earlier in this unit must also be seen as additional guidelines for an effective control system.

**5.7 Design of an accounting control system**

In the design of accounting controls two aspects should be considered, namely basic accounting controls and disciplines over basic accounting controls.

**(a) Basic accounting controls**

Basic accounting controls are designed to ensure that a public institution's transactions are valid and recorded completely and accurately in its books. When an internal control system is in the process of being designed, the following standard control techniques can be considered, together with their related objectives of validity, completeness and accuracy:

- pre-numbering of originating documents
- maintaining total accounts
- establishing batch totals of documents
- detailed checking and comparing of documents
- holding files
- authorisation of documents
- verifying records
- stocktaking and periodic cash counts
- reviews
- periodic trial balances

Since most of these techniques or procedures have already been dealt with in detail in the third year, it is important that you refer back to your third-year unit on internal control in this regard.

**(b) Disciplines over basic accounting controls**

Disciplines over basic controls may be considered for design purposes under the following headings:

- supervisory controls
- separation of duties
- custodial controls

Since these disciplines over basic controls have already been dealt with at third-year level, you should refer in this regard to your third-year unit on internal control.



### ACTIVITY

*List the aspects that can be included in the design of an internal control system.*

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## 6 IMPLEMENTATION, MAINTENANCE AND MONITORING OF AN INTERNAL CONTROL SYSTEM

The design of an internal control system is usually followed up by implementation of the system and the various types of controls and control procedures included in it. Thereafter the maintenance and monitoring of the system is important to ensure that internal controls are in place and functioning. These aspects of the internal control system will now be discussed.

### 6.1 Implementation of an internal control system

According to Atkisson et al (1986:96), the implementation and maintenance of an internal control system concerns the system's installation and subsequent administration. At this point the focus is directly on actual performance and the people involved. In this respect there is a need for administrative skills and judgement to deal with the many unforeseen developments and the unavoidable human problems.

According to Puttick and Van Esch (1996:165–166), in implementing an accounting system and related controls, management will identify the activities in which the public institution is, or will be, engaged. By analysing each type of transaction, management will be able to assess the risks to which it will be exposed at each stage. Therefore, when controls are implemented every transaction should be authorised, initiated, executed and recorded. To ensure that these tasks are done completely and accurately and that errors are detected as soon as

possible, management must decide on the controls that will be implemented as well as the purpose of each.

The purpose for which a control is implemented is more commonly referred to as the control objective. If a control objective is not achieved, the risk is increased because of the possibility of errors and irregularities. To reduce this risk, certain procedures are put in place. The control objectives and procedures will each be considered briefly:

**(a) Control objectives for implementing internal controls**

For control purposes it is essential that any accounting system ensure the following:

- that only valid transactions are recorded
- that transactions are recorded accurately
- that all transactions that occur are completely recorded

Since these control objectives have already been dealt with earlier in this unit and in your third-year course, they will not be elaborated on at this stage.

**(b) Control procedures**

To achieve the above objectives, an accounting system should incorporate certain internal control procedures. These include the following:

- adequate separation of duties within the system activities
- custody controls to safeguard the institution's assets adequately
- control over accounting records and the accuracy of recording
- authority delegated to specific individuals who may be held accountable
- adequate management supervisory checks

Since these control procedures have already been dealt with earlier in this unit and in your third-year course, they will not be elaborated on at this stage.

## **6.2 Maintenance of an internal control system**

To maintain the internal control system, it is continually necessary to ensure that the various components of the system are in place and functioning optimally. These components, as indicated previously, are the following:

- control environment
- risk assessment
- control activities
- information and communication
- monitoring



In maintaining the internal control system, attention should be given to its various characteristics to ensure that it always displays these characteristics. At the same time it is necessary that management attend continually to the various means through which they can achieve internal control (such as policies, procedures, accounting, budgeting and reporting) by ensuring that the policies and procedures stay relevant and the accounting and budgeting system are monitored for deviations. To ensure that the internal control system is functioning optimally and to take action in those cases where the system lacks total control, management should also emphasise the importance of financial and management reports that can assist them regularly. The various role players involved in internal control must also work together to ensure the optimal functioning of the internal control system. Without the co-operation of role players, the internal control system will not serve its purpose of preventing and detecting fraud, error and irregularities.

### **6.3 Monitoring of an internal control system**

According to Gauthier (1996:35), it is essential that the management of a public institution monitor control-related policies and procedures on an ongoing basis to ensure that they are continuing to function properly as designed. Management must also monitor potential problems disclosed by internal controls to ensure that they are corrected or resolved in good time. It is therefore important to keep in mind that internal controls cannot be installed once and for all and never be reviewed; they must be tested regularly to ensure that they are still functioning properly as designed. In fact, internal control monitoring should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved (GAO 1999:18). An internal control system should generally be designed to ensure that ongoing monitoring occurs in the course of normal operations. Internal controls must be reviewed continually and be integrated into the public institution's operations. This includes regular management and supervisory activities, comparisons, reconciliations and other actions people take in performing their duties.

Often the regular ongoing monitoring of internal controls can be supplemented by separate evaluations of internal controls that are useful by focusing directly on the controls' effectiveness at a specific time (GAO 1999:18–19). The scope and frequency of separate evaluations should depend primarily on the assessment of risks and the effectiveness of ongoing monitoring procedures. Separate evaluations may take the form of self-assessment as well as a review of the control design and direct testing of internal control. However, separate evaluations may be performed by auditors from the office of the Auditor-General or other external auditors. Deficiencies found during ongoing monitoring or through the separate evaluations should be communicated to the individual responsible for the function or activity and also to at least one level of management above that individual. The monitoring of internal control should include policies and

procedures for ensuring that audit findings are promptly resolved. Public managers do, however, have the following responsibilities in this regard:

- to evaluate audit findings promptly, including those that indicate deficiencies and recommendations
- to determine proper actions in response to audit findings and recommendations
- to complete, within the established time-frames, all the actions that correct or resolve the matters brought to management's attention

The resolution process begins when audit results are reported to management and is completed only after action has been taken that:

- corrects identified deficiencies
- produces improvements or
- demonstrates that the audit findings and recommendations do not warrant management action

## **7 EVALUATION OF INTERNAL CONTROL SYSTEMS**

An approach that can be followed for the evaluation of a system of internal control is for management to review the various risks that exist in a public institution (Puttick & Van Esch 1996:164–165). In terms of this approach, the evaluation of the system of internal control should focus on all the components of the system rather than on only certain aspects of the system.

### **7.1 Purpose of an evaluation of the control system**

It is important that management realises the importance of the internal and external auditors' roles in the evaluation of an internal control system. In fact, it is an integral part of the auditor's duties to evaluate the system of control that is in place and to consider any weaknesses in it and how it will affect his/her approach to an evaluation of the system (Puttick & Van Esch 1996:174). The purpose of an evaluation of the internal control system should, according to Sawyer and Dittenhofer (1996:115–116), include the following:

- to review the control risk element
- to determine the objectives of the control system
- to review the objectives and determine whether they are consistent with the institutional policy or are designed to ensure compliance with internal or external requirements
- to examine and analyse the control system to determine whether its composition is sound – in other words, establish whether a criterion, a

method of measurement of conditions, an evaluation of deviations and a method of reporting exist

- to determine whether the output of the controls is designed to accomplish its intended purpose
- to review the operation of the control system
- to determine whether the control output is achieving management's objective in establishing the control
- to determine whether the control system has the required characteristics
- to determine whether the control system is operating as intended

Although these aspects are not exhaustive, they can serve as a point of departure when management and auditors intend to evaluate the internal control system of a public institution.

## **7.2 Aspects that can lower the efficiency of the control environment**

For the purpose of assessing the suitability of internal control systems, there are some aspects that could lower the efficiency of the control environment of a public institution. The aspects, according to Pickett (1997:162–165), include the following:

### **(a) Ability of senior management to override accepted control**

Problems arise when managers are able to suspend internal controls at will to expedite a required activity. This gives rise to a situation where staff feel unable to challenge senior managers who are bypassing a standard control. It is therefore necessary that when controls are suspended there be agreement between staff and management about this, and such exceptions to the rule should be written into the procedures. Ideally they should also be subject to special checks when the unusual situation or emergency is over.

### **(b) Lack of staff and vacant posts**

Control relating to authorisation, internal checks, segregation of duties and supervision can suffer when there are insufficient staff to enact the agreed procedure. In this regard there needs to be a level of flexibility when controls are designed to cater for unusual circumstances where staff are not available. To compensate for this, it is essential that a management trail be present that allows one to ascertain who initiated a transaction for later review and consideration. Management must also assume responsibility for failing to fill vacant posts, since they cannot ignore the impact on the control process or blame it on budgetary constraints.

**(c) Poor control culture**

Internal control depends on managers and staff doing things properly. This normally takes longer and is more cumbersome to perform, which in turn takes some kind of all-round discipline. The aggregation of such discipline from all levels in the institution constitutes the control environment or control culture. Without a positive control culture, employees and even management will not comply with the established internal control mechanisms.

**(d) Staff collusion**

Many controls depend on two or more officials' involvement as a form of check over each other's activities. The idea is that if one person is corrupt, this arrangement will not allow that individual to have sole authority over one routine. At least the other person's involvement will discourage the dishonest one from proceeding with irregularities. However, it may happen that people work together to bypass the internal control procedure. As a result, although two signatures are attached to a document when transactions are reviewed, for example, these would not indicate that the transaction was correct and proper.

**(e) Reliance on a single performance indicator**

Internal controls are in place to ensure that management is able to achieve the objectives. Where these objectives are centred on performance indicators, the associated controls should recognise this. A problem arises, however, when management is given one basic indicator to work towards, which is regularly reported on. The temptation to base activities on one key factor can lead to many distortions that do not necessarily promote the institutional objectives.

**(f) Reliance on memory**

There are some controls that are dependent on knowledge held only in the minds of employees. These may relate to the identity and/or signature of authorising officials, procedures used for dealing with various activities, levels of delegated authority, key contracts and the roles of respective officials. While this gives well-deserved responsibility and recognition to long-serving employees, and as a result puts them in a special position, it can have many disadvantages. One disadvantage is a lack of clarity on the actions that the institution has authorised. In addition, inconsistency and misunderstanding can arise where there is undue reliance on the discretion of the person in question.

**(g) Retrospective transaction recording**

Some public managers feel that documentation recording and/or authorising a transaction is a matter of pure bureaucracy that interferes with the daily running of their work area. There are times when, for example, orders are placed over the telephone and the associated paperwork is compiled only many weeks later. There are also records that are processed as and when there is time available, where the relevant detail is based mainly on memory in many cases.

**(h) Uncontrolled delegation of tasks**

Responsibility does not mean that tasks cannot be delegated to various levels under a manager's command, which is in general good management practice. The danger, however, lies in excessive delegation that has not been controlled in any sense. In this scenario control suffers as staff assume responsibility for activities that should rightly be under the charge of more senior officials. It is therefore unacceptable to assign tasks without checking on the progress or caring about the outcomes or results. In this respect, delegation can either be a useful management tool or be readily abused.

**7.3 Aspects of control risk audits**

As indicated earlier, the external or internal auditors also review the control risk element as part of the evaluation and assessment of the internal control system. In fact, according to Sawyer and Dittenhofer (1996:116), control risk is a substantial element of the broad risk area. It can therefore be defined as the possibility that the controls that have been established will not detect a situation of exposure for which the control was designed. Control risk should therefore also be a consideration in the design of control methodology. On the other hand, risk in this context is a result of a compromise between the actual review of all the events and transactions and the review of representative samples. It also includes a consideration of the control methods and the quality of the personnel functioning within the control process. It is therefore important that when the auditor reviews the internal control system and process, he/she considers the control risk aspect. This risk element will serve to influence the design of the audit process, since a high risk will lead to a more stringent audit of the control system and process. Accordingly, review of the control risk becomes one of the first elements in the audit programme.

## 7.4 Assessment of operating controls

Internal auditors should be experts not only in accounting or financial controls but also in dealing with operating controls (Sawyer & Dittenhofer 1996:116). The evaluation of financial controls has been well documented and accepted over the years, whereas the assessment of operating controls has not been described to such an extent. Operating controls are therefore more difficult to assess. Often no criteria or standards have been set for appropriate control procedures and techniques for operating controls. It is therefore necessary that internal auditors recommend appropriate criteria and controls and reach agreement with management about these. As with financial controls, controls over non-financial activities must be linked to objectives and criteria. Just as financial controls are established in consonance with generally recognised or accepted accounting practice (GRAP or GAAP), so non-financial controls should be established in consonance with generally accepted management principles and practices.



### ACTIVITY

*List the aspects that should be included in the evaluation of an internal control system.*

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## **8 CONCLUSION**

From the content of this unit it should be evident that the establishment and maintenance of an internal control system in a public institution is a complex and specialised field of study. It is, however, important to give attention to internal control systems, since the statutory requirements and provisions for them necessitate thorough knowledge about the subject. The concept of an internal control system encompasses a number of aspects that public managers should take note of in future if they want to achieve the objectives of the public institution. Actually, the fact that legislation makes the existence of internal control systems in public institutions compulsory is an indication of government's intention to ensure sound, effective and efficient public management and administration. At the same time it also implies that government is serious about the principles of accountability and transparency, which will be spin-offs from the effectiveness of a system of internal control.



## 9 SELF-ASSESSMENT

1. Describe and explain the policy framework and requirements for internal control. (25)
2. Describe and explain the internal control system. (10)
3. Describe and explain the elements or pillars of an internal control system. (20)
4. Describe and explain the components of the internal control system. (15)
5. Identify and explain the characteristics of an effective control system. (25)
6. Identify and explain the role players in internal control. (25)
7. Describe and explain the internal control process. (25)
8. Describe and explain the design of an internal control system. (25)
9. Describe and explain the implementation, maintenance and monitoring of an internal control system. (25)
10. Describe and explain the evaluation of an internal control system. (25)



## 10 FEEDBACK ON SELF-ASSESSMENT

1. You should have described the policy framework and requirements for internal control by applying the knowledge that you acquired in section 2 of this unit.
2. You should have given a description of the internal control system by applying the knowledge that you acquired in section 3 of this unit.
3. You should have given a description of the elements or pillars of an internal control system by applying the knowledge that you have acquired in section 3 of this unit.
4. You should have described the components of the internal control system by applying the knowledge you have acquired in sub-section 3.1 of this unit.
5. You should have identified and explained the characteristics of an effective control system by applying the knowledge you have acquired in sub-section 3.4 of this unit.
6. You should have identified and explained the role players in internal control by applying the knowledge you have acquired in sub-section 3.7 of this unit.
7. You should have described and explained the internal control process by applying the knowledge acquired in section 4 of this unit.
8. You should have described and explained the design of an internal control system by applying the knowledge that you have acquired in section 5 of this unit.
9. You should have described and explained the implementation, maintenance and monitoring of an internal control system by applying the knowledge that you have acquired in section 6 of this unit.
10. You should have described and explained the evaluation of an internal control system by applying the knowledge that you have acquired in section 7 of this unit.

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# RISK MANAGEMENT IN THE PUBLIC SECTOR

UNIT

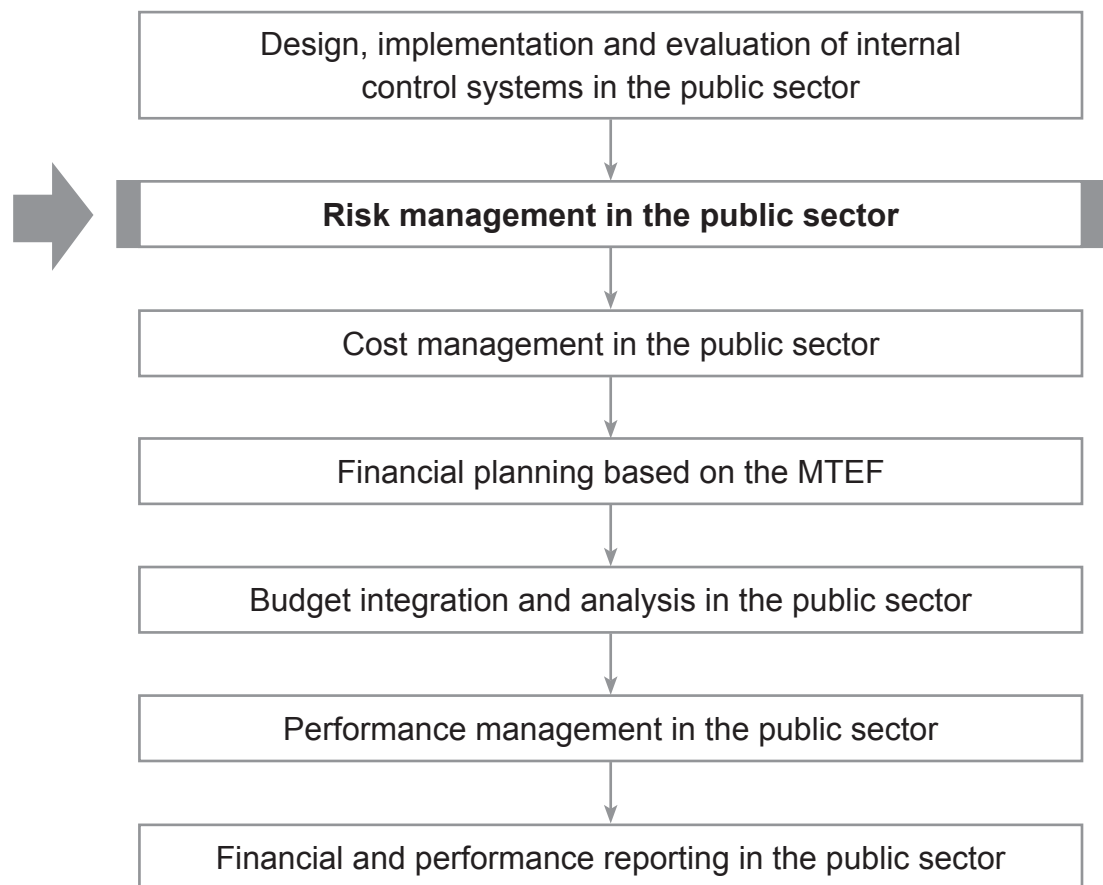
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## ROUTE MAP

Use the route map below to determine where you are within the syllabus and where this study unit fits into the module:



## LEARNING OBJECTIVES

After studying this unit, you should be able to:

- describe government objectives and risk management
- describe the necessity for risk management in the public sector
- define the concepts –
  - ‘Risk’
  - ‘Risk management’
  - ‘Enterprise risk management’
- discuss internal risks and its categories
- discuss external risks and its categories
- identify and discuss the steps in the risk management process
- identify and discuss the risk management techniques and models

## 1 INTRODUCTION

Risk management in the South African public service is fairly new and has surfaced as a management tool to support accountability, prevent corruption and wasteful use of resources. It is seen by most authors and practitioners as a fundamental aspect of organisational planning process that enhances the ability of organisations to achieve their goals. The Public Finance Management Act (1999) in South Africa sets the framework for accountable financial budgeting and financial administration and requires that Accounting Officers in public institutions put in place risk management systems to mitigate the impact the risks might have on institutions. The reason underlying the need for risk management practices in the public service is that all activities of public institutions involve some element of risk and it would be irrational for public managers to pursue a zero-risk approach. Risk involves both threat and opportunity.

This study unit provides a discussion of risk management in the public sector. The first part gives an insight about the objectives of government with the institutionalisation of risk management. The second provides the discussion of the necessity for risk management whilst the third gives a conceptual analysis of frequently used concepts. Fourthly, focus is directed to the discussion of the risk types and categories, whilst the fifth and sixth concentrate on the discussion



of the risk management process and risk management techniques and models respectively.

## **2 GOVERNMENT OBJECTIVES AND RISK MANAGEMENT**

The basic principles of service delivery (DPSA 1997) articulate the need for risk management in order to achieve of government objectives. According to the Public Sector Risk Management Framework (PSRMF 2004) public sector institutions are bound by Constitutional mandates to provide services in the interest of the public good. No public institution has the luxury of functioning in a risk-free environment; they encounter risks that are inherent in providing public goods and services. The public sector is fraught with unique challenges, such as lack of capacity, lengthy decision lead times, limited resources, competing objectives and infrastructure backlogs. These challenges place an extra risk management burden on public sector managers. Risk management is a management tool that increases an institution's prospects of success. Value is maximised when institutions set clear and realistic objectives, develop strategies, are informed of the intrinsic risks that they are faced with. Within high performing institutions, risk management is a strategic imperative rather than an option.

## **3 THE NECESSITY FOR RISK MANAGEMENT IN THE PUBLIC SECTOR**

The discussion of government objectives and risk management above has highlighted a few reasons of what government intends to achieve by making risk management an inherent part of the internal control process. From the discussion it could be deduced that the institutionalisation of risk management is a result of the changing environment within which public institutions operate. The discussion in this section answers the question 'why is there a need for risk management'. Six reasons, as discussed below provide an answer to this question.

### **3.1 Corporate governance**

Corporate governance places the accountability for risk management in the hands of the Accounting Officer of the public institution. Various legislative frameworks, notably the PFMA and the MFMA together with corporate governance codes such as King II require that public institutions implement risk management plans. These requirements are placed on public institutions to counter past organisational failures and situations at which institutions used to be caught

unaware by risk events. Internal control and other risk mitigation mechanisms, in terms of the legislative and corporate governance codes, have to be based on a thorough assessment of institution-wide risks and should strive to create opportunities for increased improved service delivery.

### **3.2 Planning and organisation**

The value of risk management is best leveraged when its principles and techniques are applied during institutional planning processes and organisation. Given the increased levels of volatility and uncertainty, it is essential that plans, particularly multiple year plans, take into consideration a thorough assessment of risks and mitigation strategies. For this purpose, existing risk management techniques and methodologies such as SWOT analysis, PEST analysis and internal reviews can be utilised to supplement the institutions risk management model. Planning and organisation and risk management are inter-dependent internal functions of public institutions.

### **3.3 Continuous risk assessment**

The risk profile of an institution changes on a continuous basis. Some risks are created by changes initiated by the institution itself, whilst others are the result of changes in society, business, legislation or communities. In such a continuously changing environment, managers must adapt strategies to keep an accurate perspective of changing risks. The risk management plan must provide the institution with the ability to systematically identify new and emerging risks, and the assurance that existing risks are being addressed in the best possible way. Changes, in particular those arising from the external environment, are often beyond the control of management but the risks that this environment create need to be managed.

### **3.4 Evolution of risk management**

Risk management has evolved over recent years. In South Africa, institutions have observed the integration of risk management techniques with fraud prevention, internal control and corporate governance. There has also been an integration of operational risk management functions into the broader umbrella of enterprise risk management. Aspects such as internal control, safety management, sustainability and environmental management, for example, have increased in importance in recent times. The broadening of risk management has seen a change in emphasis from risks as individual hazards to risks as uncertainties around key objectives. Risk management has also seen the introduction of new participants into the process. The function is no longer confined to insurance staff, internal auditors, and loss prevention functions. The wider approach to risk management has brought the function into the view of human resources

officers, compliance officers, financial managers, ICT specialists and other functional managers.

### 3.5 Internal audit plans

Internal audit plans are based on the outcomes of risk assessments. Internal auditors are increasingly basing their priorities on the risk management plan and give priority to high-risk assets and processes. Internal audit with a public institution is well-placed to independently validate key internal controls. The frameworks of internal control used by auditors are useful contributions to the risk management plan. Internal audit is a key role player in the assurance process with regard to the effectiveness of risk management.

### 3.6 Cultural adjustment

The essential behaviour of officials charged with the responsibility for various activities of risk management must change. This requires a shift in the cultural dynamics insofar as it concerns risk management, which can be achieved through awareness and advocacy, communication, coaching, training and linking to performance measures. Risk management must be a catalyst for change in behaviour of managers. Managers need to develop competencies to ensure that they make conscious risk-based decisions. Rather than viewing risk management and its associated activities as mere bureaucracy, managers need to look at it as a powerful driver of service delivery excellence.



#### ACTIVITY

*Explain the necessity for risk management in the public sector.*

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## 4 DEFINITION OF CONCEPTS

### 4.1 The concept 'risk'

The Public Sector Risk Management Framework (PSRMF 2004) herein referred to as the 'Framework', defines risk as any threat or event that is currently occurring or that has a reasonable chance of occurring in the future, which could undermine the institution's pursuit of its goals and objectives. Risks, as argued in the Framework, manifest as negative impacts or as having negative consequences on goals and objectives or as missed opportunities to enhance institutional performance.

### 4.2 The concept 'risk management'

Most large and medium-sized organisations carry out risk management to varying degrees. Risk management is a strategic component of any organisation's survival and development and forms part of management's core responsibilities as an integral part of the internal processes of an institution. Risk management is defined as a systematic process to identify, evaluate/assess and respond/address risks on a continuous basis before such risks can impact negatively on the institution's service delivery capacity.

It is a systematic process to identify, evaluate and address risks on a continuous basis before such risks can impact negatively on the institution's service delivery capacity. When properly executed, risk management gives management reasonable assurance, but not absolute assurance that the institution will be successful in achieving its goals and objectives.

### 4.3 Enterprise risk management

The term 'enterprise risk management' (ERM) has become a popular way of describing application of risk management. Enterprise risk management (ERM) refers to the application of risk management throughout the institution rather than only in selected areas of a public institution. According to the Framework, ERM recognises that risks and opportunities are dynamic, often highly interdependent and must not be considered and managed in isolation. ERM responds to this challenge by providing a methodology for managing institution-wide risks in a comprehensive and integrated way. It is a process, implemented by management and employees across the operations of an institution to identify potential events that may affect the institution.



### ACTIVITY

*Define the concepts 'risk', 'risk management' and 'enterprise risk management'.*

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## 5 RISK TYPES AND CATEGORIES

As the risk environment is varied and diverse, it becomes necessary to group potential events into risk types and categories. The two main types of risks, namely internal and external risks are identified for discussion in this study unit. These types of risks can further be subdivided into different categories of risks (PSRMF 2004). The discussion below focuses on risk types and categories.

### 5.1 Internal risks

Internal risks are internal aspects within an institution to which managers and employees have control over. These aspects may include the ability to plan, the adequacy of skills of employees, financial viability and how ethical employees may be. The aspects involve to a large extent the amount of internal risk that may be readily available within an institution. Fourteen (14) categories of internal risks have been identified for discussion in this section. These categories are briefly discussed below.

- **Human resources**

Risks that are related can have an effect on an institution's human capital with regard to integrity and honesty, recruitment, skills and competence, employee wellness, employee relations, retention and occupational health and safety.

- **Knowledge and information management**

Risks that are associated with an institution's management of knowledge and information may include availability of information, stability of information, integrity of information, relevance of information, retention and safeguarding.

- **Litigation**

An institution might suffer losses due to litigation and lawsuits. Losses from litigation can emanate from claims by employees, the public, service providers and other third party organisations or individuals. These risks might also include failure by an institution to exercise certain rights that are to its advantage.

- **Loss or theft of assets**

These refer to an institution losing important assets due to either theft or loss. Important assets that might have a crippling impact on a government institution, for example, might include state vehicles, computers and other expensive assets.

- **Material resources/procurement risk**

The risks relating to an institution's material resources may include availability of material, costs and means of acquiring or procuring resources and wastage of material resources. Common examples of waste of government material may include public officials using official working hours for personal gain and abuse of state vehicles.

- **Service delivery**

Service delivery risks refer to risks that are associated with poor services and the inability of government institutions to deliver in time of need to meet the expectations of communities. Recent service delivery protests in South Africa are an expression of the dissatisfaction by members of communities about the speed of service delivery.

- **Information technology**

These refer to risks associated with an institution's IT objectives and infrastructure requirements. Possible considerations may include security concerns, availability of technology, applicability of IT infrastructure, integration or interface of systems, effectiveness of technology and obsolescence of technology.

- **Third party performance**

The risks in this category include those that are related to an institution's dependence on the performance of a third party organisation or individual. They may include the likelihood that the service provider might not perform according to the service level agreement. Nonperformance may include outright failure to perform, not rendering the correct service in time and inadequate or poor quality of performance.

- **Health and safety**

The risks that are associated with health and safety emanate from occupational health and safety issues in public institutions. A few examples of the risks in this category may include injury on duty and outbreak of disease in an institution.

- **Disaster recovery or business continuity**

Disasters can have severe impacts on the normal functioning of a public institution. For example, natural disasters and acts of terrorism can lead to disruption of processes and service delivery and could include disruption of operations. Factors that require consideration may include disaster management procedures and contingency planning.

- **Compliance/regulatory**

These refer to the risks that are related to compliance requirements that an institution has to meet. These risks may include failure to monitor or enforce compliance as well as fines and penalties being paid. Noncompliance with the Public Finance Management Act (1999) and Employment Equity Act (1998) poses a serious threat to most public institutions in South Africa.

- **Fraud and corruption**

Fraud and corruption refers to illegal or improper acts by employees resulting in a loss of the institution's assets or resources. Manipulation of the tendering procedure by government officials to award tenders to relatives and friends is a typical example of fraud and corruption from which government suffers immensely.

- **Financial**

These refer to the risks in the scope of general financial management in the institution. Potential factors that should be considered include cash flow adequacy and the management thereof, financial losses, wasteful

expenditure, budget allocations, integrity of financial statements, revenue collection and increasing operational expenditure.

- **Cultural**

The risks in this category relates to an institution's overall culture and control environment. The factors that are related to organisational culture include communication channels and their effectiveness, cultural integration, enforcement of ethics and values, alignment of roles and management style.

- **Reputation**

The risks in this category may include factors that could tarnish an institution's reputation, public perception and image.



### **ACTIVITY**

*Explain internal risk and list the categories associated with internal risk.*

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## **5.2 External risks**

The external environment consists of economic, physical, political, social, natural, technological and legislative environments. The external environment consists of factors and forces that are beyond the control of a public institution and that affect the decisions, strategies, procedures and performance of public institutions. The risk categories identified in the external environment are discussed in subsequent sections.



- **Economic environment**

The economic environment as a risk category carries numerous risks for public institutions. The impact of the recent economic recession is a good example of the risks that are associated with the economic environment. Factors that have to be considered include the inflation, foreign exchange fluctuations as well as interest rates.

- **Political environment**

Public institutions operate in and are influenced by developments in the political environment. The risks associated with the political environment might include political unrest, local, provincial and national elections as well as changes in political office bearers.

- **Social environment**

The risks in this risk category refer to those emanating from the institution's external social environment. Possible social factors that require consideration include unemployment, migration of workers and other pertinent socioeconomic problems.

- **Natural environment**

This refers to risks relating to the institution's natural environment and whose impact can disrupt internal operations of a public institution. A few factors that might require to be considered include depletion of natural resources, environmental degradation, spillage and pollution.

- **Technological environment**

The technological environment encompasses new work methods and procedures, new technological innovation, new products, the state of technology for maximum inputs and outputs, the obsolescence of technology and the dynamic changes that frequently occur in technologies which enable organisations to get a competitive advantage. The risks in this category relate to the effects of advancements and changes in technology on public institutions. Changes in the technological environment might have dramatic effects on public institutions. An institution may have invested in particular technological equipment and training only to see a new, more innovative and cost-effective technology emerge.

- **Legislative environment**

The legislative environment provides guidelines to public institutions on the manner in which they have to operate. Public institutions, as compared to

those in the private sector, are expected to comply with all the legislative requirements. The risks in this category may include changes in legislation and conflicting legislation. The two mentioned examples could hold both negative and positive consequences for public institutions.

The discussion in subsequent parts of this chapter draws on the findings of the research commissioned by the Public Service Commission of South Africa (PSC 2003). The reason underlying the choice of PSC's research findings as a point of departure is that they reveal international experiences gathered from countries at which risk management has proven to be a success. In addition, the risk management process and techniques that the PSC draws attention to, are not only limited to strategic management implementation in public institutions, but can be cascaded down the various levels of a public institution.



### ACTIVITY

*Explain external risk and list the categories that are associated with external risk.*

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## 6 THE RISK MANAGEMENT PROCESS

Risk management is an ongoing process that consists of consecutive steps, but not a once-off event. It is a procedural practice and a course of action that practitioners have to follow carefully in order to be successful in achieving its intended goal. In terms of the PSC's (2003:9) research findings, the risk management process consists of the steps that provide guidance of how an effective risk management framework can be developed. As illustrated in figure 2.1, the risk management

process consists of five consecutive steps that include establishing the context and control environment, risk identification, risk analysis, risk treatment and risk control.

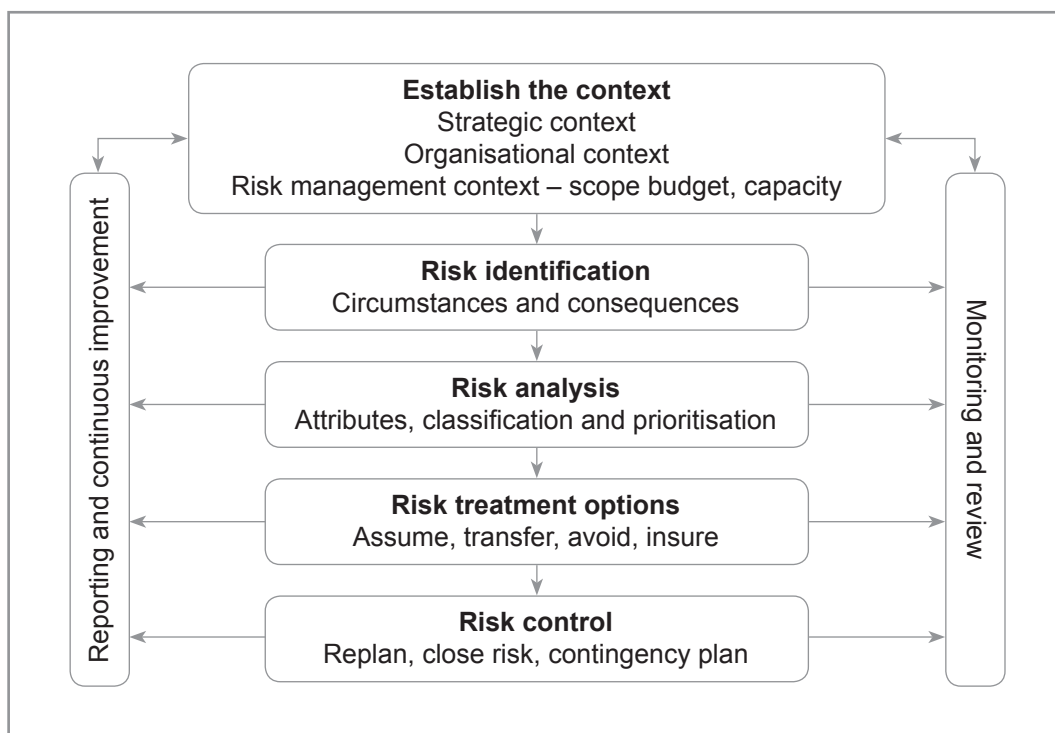


Figure 2.1: Risk management process (PSC 2003)

## 6.1 Establishing the context and control environment

As depicted in figure 2.1 above, the first step in the risk management process entails activities with which management establishes the risk context and control environment. The context in which risks are perceived to exist and to which risk management interventions have to respond to are identified in this step. One way of understanding the risk context of an institution is by examining the micro and macro environments and the changes that occur in these environments.

- **Scanning the environment**

The scanning of the environment helps management to identify issues that might affect the institution from both the internal and external environments and those issues that affect other institutions with which the institutions interacts. Environmental scanning includes identifying the opportunities and strengths of the institution. The internal operations of an institution, during environmental scanning, must also be scanned to determine the risks associated with relations between various units of the institution. During environmental scanning, components of both the (micro) internal

and (macro) external environment should be scanned to detect possible threats and hazards.

- **Risk management policies and objectives**

The risk management policy communicates the goals and objectives that management intends to achieve and ensures that stakeholders understand the value that management assigns to the risk management process and activities. All employees within an institution have to understand their roles in contributing to the achievement of the institution's risk management objectives. After the risk management policy has been developed, it is important that managers pay attention to the development of risk management strategies that will be used to achieve the objectives outlined in the policy. The risk management strategy serves as a basis for performance measurement that the institution will conduct at predetermined intervals such as monthly, quarterly or yearly.

- **Organisational structure**

Public institutions differ in terms of both size and financial capacity. Large institutions that have sufficient funds can afford to establish a dedicated risk management unit and often do have such a unit. However, in other cases where institutions do not have sufficient funds for a dedicated risk management unit, they usually assign an employee at a senior level to be responsible for risk management within the entire institution. The responsibilities of the risk manager or risk management unit are to develop, implement, and monitor the institution's risk management programme. In the case where a dedicated risk management unit exist, the head of the unit reports to the accounting officer of the institution. Employees in the risk management unit report directly to the head of the risk management unit. The size of the risk management unit must be compatible with the functions of the institution, its risk exposure, and its financial capacity.

- **The division of authority, responsibility and accountability**

In a well organised public institution, the organisational structure indicates the division of authority and responsibilities that are assigned to employees performing specific functions. In the case of the risk management unit, the appointment of a risk manager ensures that risk management receives attention in the entire institution. The usual responsibilities of the risk manager are planning, organising, coordinating, implementing, monitoring, and controlling the institution's risk management programme.

Despite the roles that managers play in mitigating risks, each employee in the public institution is assigned responsibilities regarding risk management

as it relates to their functional area. The senior managers are usually responsible for developing the risk management policies, to support and implement the risk management process within the institution. The Accounting Officer of an institution is responsible for managing the activities of all employees in the organisation, which includes risk management activities of both risk management staff and those at line departments. The Accounting Officer should also issue directives to employees to support risk management activities to ensure that it is taken seriously.

The responsibilities of the line managers are different to those that are carried out by the Accounting Officer. Line managers' responsibilities would normally include implementing the institution's risk management techniques in their functional areas. This is because most of the risks occur during the service delivery process. Line managers are responsible for the preparation of contingency and mitigation plans to manage risk. They also have to cooperate with each other and to share information about the status and the causes of risks.

Support staff, which report to line managers in an institution also play an important role in managing risk within their functional areas. For instance, human resource managers need to manage the exposures that are relevant in managing personnel. The financial manager, on the other hand, has to manage financial exposures and attribute risk expenditure to specific programmes.

- **Risk appetite**

Management in a public institution responsible for the development of the risk management policy. This risk management policy has to define the risk appetite of the institution as a whole. In general, the risk appetite directly determines the amount of resources (human and financial) that the institution should put aside in order to deal with risks. Within a public institution, senior management has to define risk tolerance levels that are consistent with the risk appetite set for the institution concerned.

- **Defining overall tolerance levels and acceptance criteria**

Risk appetite refers to the level, amount and type of risk that an organisation is willing to accept. Different public institutions have different risk tolerances. This amount of risk is judged to be tolerable and justifiable (Leitch 2009). One institution may perceive a particular threat as constituting a high risk, while another may perceive it as constituting low risk. This makes it important for senior managers to establish the broad criteria for classifying and accepting risks guiding the risk prioritisation process. Risk tolerance levels are expressed in terms of the institution's budget. For instance,

criteria can be set to determine whether risks that are higher than a given percentage of the budget are regarded as high, medium, or low impact risks. This criterion guides the risk classification exercise during the risk management process. It is the responsibility of senior management to define the tolerance levels in relation to the institution's risk appetite as defined in the risk management policy.

- **Setting of available budget**

Risk management activities, like other processes that institutions embark on, have costs associated with them. The usual costs that are associated with the risk management process costs can be divided between mitigation costs and contingency costs. Mitigation costs are those that are incurred to minimise the frequency and/or occurrence of risks. Mitigation costs are upfront costs and cannot be avoided whilst contingency costs refer to those costs that are incurred after certain risks have occurred. In general, the institution's budget set aside for risk management covers both of the mitigation and contingency costs. It is common practice to estimate both mitigation and contingency costs on the basis of the information obtained from the risk assessment.

- **Defining the scope of risk management**

Risk management involves the utilisation of financial and other resources (eg human resources). Therefore, defining the scope of risk management is common practice among the institutions. The scope of risk management involves defining the scope and depth of risk management, determining whether it will focus on the whole institution or on specific units of the institution. It also has to clarify whether complicated and advanced risk management techniques are desirable in the context of the services the institution or unit is delivering.

- **Assessing the organisation's risk management capacity**

The scope of risk management places a further burden on managers to assess whether the organisation or institution has a complementing risk management capacity to be effective in responding to the depth of the risks. This involves assessing the capacity of organisational resources to undertake the risk management function effectively. It covers reviewing organisational risk management practices, risk management processes, and the adequacy of human resource skills in managing risks in general.

## 6.2 Risk identification

The identification of risks is the second step in the risk management process and determines which risks are likely to affect the institution and the characteristics of each. Risk identification is not a once-off event; but rather an activity that has to be performed on a regular basis. The risks that are associated with the delivery of services are identified on all levels of the organisation and from a variety of sources. Risk identification should address both internal (pure risks) and external (speculative) sources of risks. Internal risks are internal aspects within an institution to which managers and employees have control over, while external risks are aspects that are beyond the control of managers and employees. Risks are identified taking into account those activities that support both financial and non-financial objectives.

The most important components of risk identification are a risk statement and risk context. The risk statement usually specifies the cause of the concern as well as its impact. In general, the statement has to be clear, concise, and informative to facilitate easy understanding. For instance, the following could be used as a risk statement: “*given the <condition> there is a possibility that <consequence> will occur*”. The risk context explains the circumstances, contributing factors and interrelationships that all contribute to the risk identified.

## 6.3 Risk analysis

Risk analysis helps managers with defining and analysing the dangers to public institutions posed by potential natural and human-caused events. Risk analysis involves examining the risk in detail in order to determine the extent of individual risks, how they relate to each other and their relative importance. Risk analysis is divided into three parts. These parts are risk attributes, risk classification and risk prioritisation.

- **Risk attributes**

The concept attribute is widely used to refer to the characteristics or features of a particular risk. Firstly, the attribute of risk needs to be evaluated. The process of evaluating attributes involves estimating the impact and assigning monetary values, determining the probability or frequency of occurrence, and assigning a timeline over which the risks are more likely to occur and during which mitigation actions will be taken. The estimates of the impact can either be in terms of the percentage of the total budget or in terms of normative ranking, ranging from very severe (high) to minor (low). The probability of occurrence is usually expressed as a percentage or in terms of normative ranking, ranging from very high to very low. The period is expressed in weeks, months, or even years depending on the nature of the services the department delivers.



- **Risk classification**

Secondly, after identifying the characteristics and features associated with risks, it becomes necessary to classify them into categories. A risk classification process groups risks that are related, to build an effective mitigation plan. Risk classification also helps in eliminating those risks that are identified more than once but with different risk statements. Risks can be classified according to their characteristics or features (attributes) or sources. In the case of classifying risks according to their attributes, a table is usually used to map the risks based on their frequency of occurrence and severity of impact. Table 2.1 below depicts the classification of risks in terms of their frequency of occurrence.

**Table 2.1: Risk classification attributes (PSC 2003:12)**

Categories		Severity	
		Low	High
Frequency	Low	1. Low frequency/low severity	2. Low frequency/high severity
	High	3. High frequency/high severity	4. High frequency/high severity

Table 2.1 above classifies the risks according to the magnitude of the financial impact that they might have on the operations of an institution and can alternatively be classified in terms of their sources of origin. The classification of risks is dependent on the nature of the business of the institution. For instance, risks can be classified under headings such as contractual, financial, operations, external, legal, etc. Irrespective of which classification system is adopted, the importance of classifying risks help management to be able to prioritise them and to allocate responsibilities and resources.

- **Risk evaluation**

Despite the classification of risks in terms of their frequency of occurrence and sources of origin, risks are also prioritised. Risk prioritisation is important in guiding management regarding which risks should receive full funding and to which management must actively be involved with. Risk prioritisation requires an institution to establish criteria for ranking risks and broad policy options for dealing with risks falling under various ranks. Risk management policy should indicate prioritised risks (in categories) and the criteria that will be used to deal with them.



Risk tolerance is defined as a percentage of the total budget of the institution, ie risks whose expected costs exceed or are below a given budget threshold are dealt with according to treatment options that are available to the institution. It is also customary to prioritise risks according to their perceived impact in cases where a monetary estimate cannot be easily linked to a particular risk. For instance, it is difficult to attach a monetary estimate to a damaged public image. The level of risk is either acceptable or unacceptable.

Acceptable risks do not have any specific treatment plans although periodic review is necessary. Unacceptable risks are treated by either eliminating them or minimising their impact on the operations of the institution. Classifying risks as acceptable does not mean that they are not important: they still have to be tracked down and managed passively. Unacceptable risks are managed actively because of their potential consequences. Each of the risks must have a risk owner who is responsible for implementing the risk action plans.

## 6.4 Risk treatment and contingency plans

Risk treatment and the development of contingency plans is the fourth step in the risk management process. The discussions in this section focus on risk treatment options that are available for use by management in public institutions. According to the PSC (2003:13) the options that are available for treating risks are *avoiding, reducing, transferring, insuring* and *assuming risks*. Risk treatment and contingency plans involve preparing detailed contingency plans for mitigating the risks that pose a threat to the operations and performance of an institution. Contingency plans refer to flexible action steps that will be taken if an identified risk event can occur. This step also involves an evaluation of treatment options and the implementation of the preferred option for each of the risks identified.

**Avoidance** of risks involves the decision not to proceed with a particular programme or project or even choosing an alternative way of achieving the same outcome.

**Reducing the level of risk** involves the reduction of frequency by putting in place appropriate internal control arrangements. It also involves mitigating the impact by employing appropriate strategies such as contingency plans and contract arrangements.

**Transferring risk** to another party involves shifting responsibilities for delivering certain services such as in Public Private Partnership arrangements and contracting out. In general, risks are transferred either in part or as a whole. This option, however, gives rise to other risks such as those associated with compliance.

**Insuring the risks** is another form of risk transfer and involves taking out insurance policies. Such insurance can either be in-house or can be purchased from outside providers. In South Africa private insurance companies provide insurance services to individuals and organisations such as public institutions. However, the services are provided at a cost paid in monthly premiums.

**Assumption of risk** refers to accepting the consequences of risks on day-to-day operations of an institution. The risks whose consequences are accepted do not involve large financial consequences. Each of the treatment options has to be evaluated for its cost effectiveness. This is because no particular option would be ideal for all risks under consideration. Managers have to ensure that implementation of a particular treatment option yields the intended benefits to the institution. The implementation of the treatment options has to be done according to the risk management plan of an institution.

## **6.5 Monitoring and evaluating risks**

Monitoring and evaluation are important steps in the risk management process. The purpose of monitoring is to collect accurate, timely, and relevant risk information and to explain it in an understandable way. The information is used for control purpose and can be about budgets, operational processes, risk attributes or risk contingency action plans. Monitoring is conducted during all steps in the risk management process. The project or programme manager is responsible for reviewing the major risks that are relevant to a particular project. As part of monitoring, reviews are done at predetermined intervals for the duration of the project or programme to identify any changes in status of individual risks in the risk register.

Internal audit units and audit committees play an important role in the evaluation of risk management policies and implementation plans. These ensure that adequate systems are in place for preventing risks from occurring. Internal control systems are an integral part of monitoring and evaluation. For example, physical on site inspections during infrastructure development projects can best be monitored to ensure that developers meet the time deadlines and to prevent operational risks.

## **6.6 Controlling risks**

Controlling risks, as depicted in figure 2.1 was identified as the fifth step in the risk management process. Controlling risks helps management in making informed, timely, and effective decisions about risks and action plans. The information provided from the monitoring exercise is used to decide on the appropriate control actions to correct the situation. The decisions that are made during the control process usually involve re-planning risk treatment, invoking a contingency plan, or continued monitoring where progress is satisfactory.

## 6.7 Communication and the reporting of risks

Communication and the reporting of risks are important for the purpose of creating awareness about risks that the organisation is faced with. When stakeholders are informed of possible risks, they are able to take precautionary measures to ensure that their impact is not as severe as it might have been if they had been uninformed. Risks are usually reported on a periodic basis such as weekly, monthly, quarterly, or yearly. The risk management reports usually rank risks in order of priority to highlight those that warrant management's attention. Although the reports are compiled periodically, in cases where new risks occur before the reporting period, they should receive immediate management attention. Immediate management attention ensures that action is taken immediately to counter the severity of impact of the risk. Risks are usually reported according to their classes or categories as outlined in the risk analysis. This allows decisions to be made regarding which risks to include in the report. In general, the risk management reports are compiled for submission to the accounting officer of the institution concerned.

## 6.8 Continuous improvement

It is important that improvements or lack thereof are traced continuously. This involves the comparison of the situation at the start (of the project or programme) with the situation that prevails at the end of a given period. It is done to determine the effectiveness of risk management activities that have been undertaken over the period of time. The lessons learned are then used to improve the entire risk management process. It is important to utilise the results of risk audits and share them with other programmes and projects to ensure continuous improvement of the whole organisation.



### ACTIVITY

*List the steps that are involved in the risk management process.*

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## 7 RISK MANAGEMENT TECHNIQUES AND MODELS

The risk that cannot be completely dealt away with requires appropriate attention from that manager in a public institution. The management of risks is done through a number of techniques and models, a few of which are explained in subsequent sections of this study unit. In practice, the choice of and use of risk management techniques is dependent on the nature of the services that the institutions provides to the public. Apart from the nature of services, the knowledge of employees performing risk management activities is of paramount importance since it enables them to make the correct choice of appropriate techniques. The techniques that are discussed in this section are not exhaustive; but reflect on those that are widely used and accepted.

### 7.1 Strategic risk analysis

The techniques involved in the strategic risk analysis are usually used to determine levels of service delivery that balances risks and benefits. These techniques are generally used to inform strategic decisions in the institution. The techniques do not necessarily depend on quantitative models, but instead, they rely heavily on intuition and knowledge. The techniques that are involved in the strategic risk analysis techniques are the SWOT analysis and the PEST analysis as discussed below.

- **SWOT analysis**

The SWOT analysis technique outlines strengths, weaknesses, opportunities and threats facing the institution. The strengths and weaknesses relate to the internal operations of the institution. By focussing on internal operations of the institution (strengths and weaknesses); the SWOT analysis technique examines the internal capacity of an institution to perform certain activities or to achieve certain results. The opportunities and threats originate from the external environment of the institution and require the institution to have enough capacity or competence to take advantage of the opportunities and to minimise or turn threats into opportunities. After the external environment has been examined, the results are used to inform the decision regarding the strategies that should be adopted.

- **PEST analysis**

The PEST analysis involves an analysis of the organisation's exposure to political, economic, social and technological risks. Political risks involve the possibility that certain government services might decline in priority thereby resulting in lower budget allocations for the public institution.

Economic risks originate from economic fluctuations and changes in major economic variables such as inflation and interest rates. Social risks refer to the acceptability of the public institution by members of the society or community as well as the effectiveness of the services the institution provide. Technological risks arise from changes in technology that can make some of the institution's assets obsolete. As in the case of the SWOT analysis, the results of the PEST analysis are used to inform strategic decisions of a public institution.

## 7.2 Operational risk analysis

The techniques that are involved in the operational risk analysis are usually used to determine the levels of investment in operating projects or programmes of a government department. The results of the techniques are usually used to inform operational decisions at the project level. The difference between strategic risk analysis and operational risk analysis techniques is that the strategic risk analysis techniques are used to inform the strategic decisions whilst the operational risk analysis are used to inform operational decisions. The difference between the two is the levels at which the decisions are made. The techniques that are involved in the operational risk analysis include the NPV, IRR and the cost-benefit analysis. They are discussed in subsequent sections of this unit.

- **Net present value (NPV)**

The NPV model is usually used to measure the benefits of undertaking a particular programme or project in excess of the costs of implementing it. It considers the time value of money discounted at a rate considered appropriate. The discount rate is usually called the cost of capital. If the net present value (NPV) of the project is greater than or equal to R0, it means that the organisation will earn a return on investment greater than the cost of capital. In this case, the project is usually accepted and implemented. If there are no benefits or return on investment from the project, it is usually not accepted and implemented. The value of money that is invested in projects or programmes and the benefits of such projects or programmes are the overriding factors that determine their acceptability.

- **Internal rate of return (IRR)**

The IRR method uses the discount rate that equates the present value of cash flows with the initial investment of a project. Thus, the net present value of the investment is equated to zero. If the internal rate of return (IRR) is less than the opportunity rate of interest, then the investment is rejected, but if the IRR is higher than the opportunity rate of interest, the investment is accepted. The IRR is based on the assumption that, if the

IRR used exceeds the cost of funds used to finance the project, then surplus funds will remain after paying for the project.

- **Cost-benefit analysis**

The cost-benefit analysis involves an analysis of benefits and costs associated with projects or programmes. The benefits and costs in this case are not strictly monetary; they can also be non-monetary. Cost-benefit analysis is a starting point for implementing any project or programme and is similar to a feasibility study that is undertaken for very large projects. Whereas the NPV and IRR models rely heavily on monetary values of variables, the cost-benefit analysis method is suitable for evaluating service delivery effectiveness in the public sector. The cost-benefit analysis takes account of non-monetary benefits that are associated with the services that are delivered by government departments or public institutions. For instance, the construction of a toll road between two towns might yield benefits to government in terms of toll revenue. This means that the fees derived from toll revenue will benefit both the government and the society. Examples of these are increased economic activity between the two towns, which leads to increased employment and low accident and death rates among those who use the road.

The benefits of this kind are not readily quantifiable. Therefore, in this case, even if results of project evaluation using NPV, IRR or any other quantitative models suggest that the project is not viable, it might still be worth undertaking, considering the non-monetary benefits. Unquantifiable costs of this particular project might include environmental degradation and damage to the landscape. Thus, cost-benefit analysis requires the use of experts to identify the potential costs and benefits, especially those that are non-monetary. Since cost-benefit analysis is usually comprehensive, it takes into account all possible options.

### **7.3 Risk identification**

The two sections discussed above concentrated on the risk management techniques that can be used to inform strategic and operational decisions in a public institution. In this section concentration is directed to those techniques that are used for risk identification. Six techniques have been identified for discussion in this module.

- **Structured and facilitated “brainstorming” sessions**

These kinds of brainstorming sessions consist of a particular structure where there is a facilitator and a broader panel of members of participants. Participants refer to members of the government department who all have different backgrounds and who perform different functions in the government department or institution. The role of the facilitator is to

facilitate the discussion and to solicit input from each participant. In terms of structured and facilitated brainstorming sessions, the members of an institution organise a session in which each of them comes with ideas about possible risks that the institution is likely to face. Commonly, the institution's risk team is composed of individuals from all backgrounds and beliefs to give risk identification a comprehensive coverage. The most important consideration in these sessions is that risks are not only those occurrences that management considers risky. The views of all the individuals in various levels of the government department are taken seriously and given sufficient attention during the brainstorming session.

- **Structured interviews**

Structured interviews usually have predetermined questions that the interviewer will ask a group of respondents. The members of the risk team of a public institution conduct structured interviews with individuals or groups of individuals to get information about the details of risks, new risks, or for checking areas of the project that requires to be planned for again.

- **Technical evaluations**

Technical evaluations include failure modes and effects analysis, reliability analysis and maintainability analysis that are used to identify potential problem areas that the organisation might be faced with.

- **Prompt and checklists**

Prompt and checklists are used to facilitate brainstorming or interview sessions. They contain issues and/or processes that are relevant to risk management and are of concern to management. They can be tailored to specific types of work to ensure that all the relevant information is captured.

- **Network analysis**

The network analysis is used to identify areas of the project that may be at risk. This analysis is often done by observation of the project schedule and uses the information on various stages for achieving the same result. For example, erecting an underground water system might involve a number of stages each with its specific schedule. Each schedule is assigned an estimated duration based on the time it takes to complete. The stage with the longest duration provides an estimate of the latest finishing period, whereas the stage with the shortest duration provides an estimate of the earliest finishing period.



- **Appointment of consultants or experts**

External consultants or experts are usually appointed in situations where the area of service delivery is new and sufficient knowledge and skills are not available within public institutions. The appointment of external consultants or experts is common in the case of technology projects such as information technology (IT) and feasibility studies for major development projects. The consultants or experts are appointed to identify the risks associated with the project based on their professional knowledge.

- **Other risk identification techniques**

Although the discussion above highlights six techniques that can be used for the purpose of identifying risk, the list, as stated earlier, is not exhaustive. There are six other techniques that can be used for the same purpose. These additional techniques include the modified Delphi interview, comparison with experience, decomposition, probabilities and decision trees, product approach as well as the hazard and operability studies (cf, PSC 2003). These risk identification techniques are not considered for discussion in this course unit.

## **7.4 Risk assessment**

The techniques that are used to assess risks can be numerical or non-numerical. A number of techniques that are generally used for risk assessments are briefly discussed below. Those that are identified for discussion include PERT, Monte Carlo analysis, simple probabilistic evaluation, fault trees analysis, and life cycle cost analysis techniques.

- **Programme evaluation and review technique (PERT)**

The PERT technique was developed to address the lack of reliable schedules produced by network analysis in project scheduling. The technique enables the degree of schedule uncertainty to be measured. It uses a statistically derived expected duration for individual activities, based on three estimated durations. These estimated durations are:

- Optimistic duration – the minimum time in which one would expect to complete the task
- Most likely duration – the time in which one would normally expect to complete the task
- Pessimistic duration – the maximum time in which one would expect to complete the task



These estimates are in turn used to calculate an expected duration for each activity and an expected duration for a sequence of activities.

- **Monte Carlo analysis**

The Monte Carlo analysis procedure uses randomly generated data to simulate a defined process to produce a realistically possible result. It is the same principle, eg roulette wheel, as found in a gambling casino in Monte Carlo. The simulations are repeated many times to produce a set of possible results whose likelihood can be determined by the application of statistical principles. Like PERT, this technique uses three estimated durations for each activity. The procedure is repeated several times to produce a set of completion dates that are normally distributed around the arithmetic mean. As with PERT, statistical principles are then used to predict the likelihood of completing a schedule within a specific date or range of dates. Although this technique is usually used for project scheduling, it can also be applied to other areas such as demand forecasts or usage of public facilities.

- **Simple probabilistic evaluation**

The simple probabilistic evaluation establishes risk levels by using simple estimates of probabilities on impacts of risks. The use of this technique is ideal where the probability factor of a risk is a single value or where the risk level is a straightforward combination of impacts. The estimates from this technique can be used to draw up a contingency fund for risk management. When this method is used in conjunction with fault and event tree analyses, it is usually called failure mode and effect analysis (FMEA). It also allows for the classification of risks according to their severity of impact.

- **Fault tree analysis**

The fault tree analysis is a top-down approach to assess the effects of faults on the performance of the department or a specific process. It identifies events that can possibly happen and their effects in terms of faults on the system and traces their sequence of occurrence to locate the origin of faults. The logic is that if certain components in a sequence normally work, then the preceding components also work. This would mean that a fault that caused system failure is further down the sequence rather than before the actual point of testing.

- **Life cycle cost analysis**

The life cycle cost analysis technique involves assessing the total costs associated with a particular programme or project from the time it was initiated to the end of its life span. This ensures that both recurrent and once-off costs are identified and are taken into account in making decisions. In this way, all the relevant risks are taken into account and quantified.

- **Other risk assessment techniques**

Despite the techniques that have been discussed above, three additional techniques for risk assessment can further be identified. These techniques include the controlled interval memory technique, sensitivity analysis technique and the event tree analysis technique. The techniques are not considered for discussion in this module.



## ACTIVITY

*List the risk management techniques and models.*

This image shows a single page of white paper with horizontal blue or grey ruling lines. The lines are evenly spaced and run across the width of the page, leaving small margins at the top and bottom. There are no vertical margin lines, and the page is completely blank except for the lines themselves.

## **8 CONCLUSION**

The discussion in this study unit focused on risk management in the public sector. Various discussions, most notably those relating to government objectives and risk management as well as the necessity for risk management in public institutions have highlighted reasons why there is a need for the institutionalisation of risk management in public institutions. From these discussions it can be concluded the major reasons for institutionalising risk management as an integral part of the internal control process of public institutions is that, public institutions do not operate in a risk-free environment. But they are confronted by challenges for which they need to continually plan and monitor. The risk management process in public institutions requires that managers adapt strategies to overcome both the threats arising from within and those from the external environment of public institutions. The discussion of the risk management techniques and models highlights internationally tested tools which managers and other employees in public institutions can use to lessen the severity of individual threats faced by their institutions. All these risk management activities are carried out to preserve scarce resources at the disposal of government institutions and to increase the levels of service delivery to meet public expectations.



## 9 SELF-ASSESSMENT

1. Describe government objectives and risk management. (5)
2. Describe the necessity for risk management in the public sector. (25)
3. Define the concepts –
  - 3.1 'Risk' (5)
  - 3.2 'Risk management' (5)
  - 3.3 'Enterprise risk management' (5)
4. Discuss internal risks and its categories. (25)
5. Discuss external risks and its categories. (25)
6. Identify and discuss the steps in the risk management process. (25)
7. Identify and discuss the risk management techniques and models. (25)

## 10 FEEDBACK ON SELF-ASSESSMENT

1. You should have described government objectives and risk management by applying knowledge and insight gained in section 2 of this study unit.
2. You should have described the necessity for risk management in the public sector by applying the knowledge acquired in section 3 of this study unit.
3. You should have defined the concepts by applying knowledge and insight acquired from section 4 of this study unit.
4. You should have discussed the internal risks and its categories by applying knowledge acquired in subsection 5.1 of this study unit.
5. You should have discussed the external risk and its categories by applying knowledge acquired in subsection 5.2 of this study unit.
6. You should have identified and discussed the steps in the risk management process by applying knowledge acquired in section 6 of this study unit.
7. You should have identified and discussed the risk management techniques and models by applying the knowledge acquired in subsection 7 of this study unit.

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# COST MANAGEMENT IN THE PUBLIC SECTOR

UNIT

3

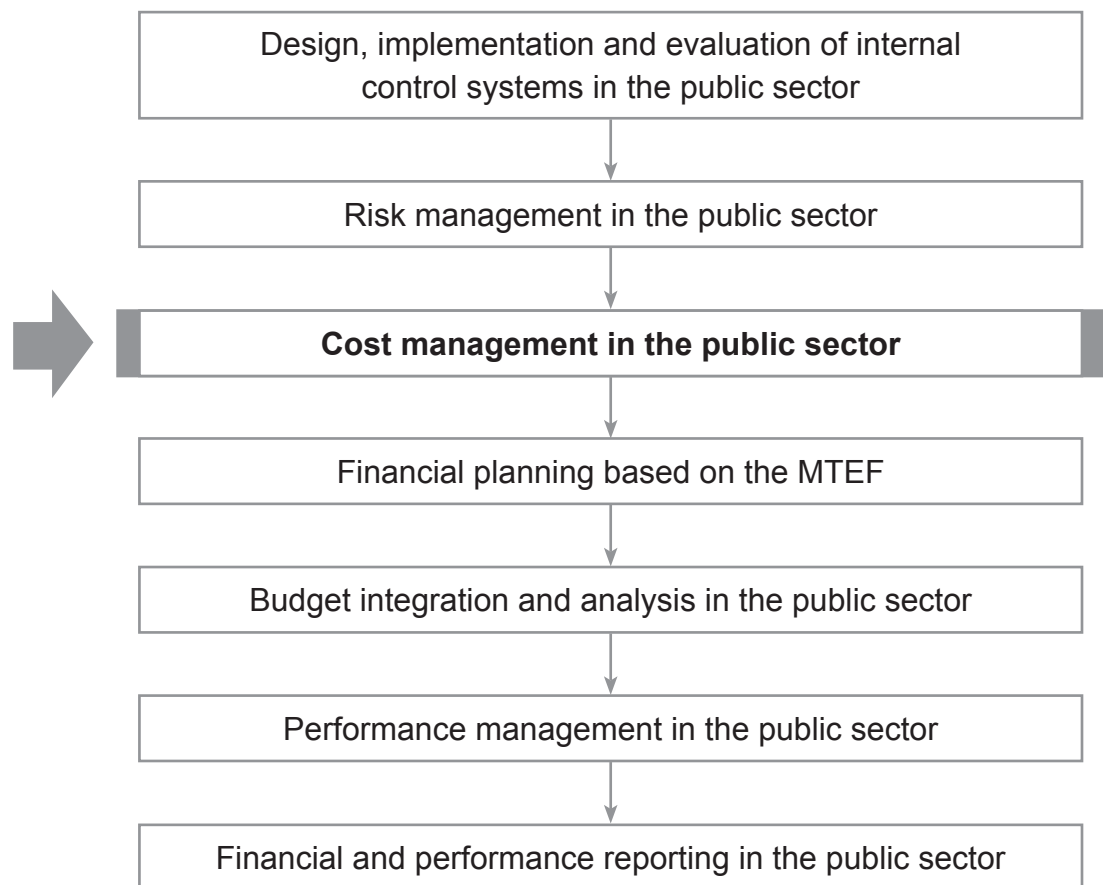
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## ROUTE MAP

Use the route map below to determine where you are within the syllabus and where this study unit fits into the module:



## LEARNING OBJECTIVES

After studying this unit, you should be able to:

- define and illustrate a cost object
- distinguish between direct costs and indirect costs
- explain the relationships between cost drivers, variable cost and fixed cost
- explain the importance and relevance of accounting information
- state the difference between financial accounting and cost and management accounting
- describe the elements of a cost accounting system

## 1 INTRODUCTION

In order to deliver to meet the expectations of the general public, public institutions carry out and engage in various operations and activities. The operations and activities to which public institutions engage and associated with and are costly. Costs constitute various elements of public institutions in monetary terms. Basically costing means that a price is fixed to every conceivable expenditure item in order to determine total expenditures, arranging of loans if necessary, revision of business plans, and so forth. In other words, costing serves to support business decisionmaking, since it provides the actual costs involved in the management of a business enterprise or state department. Cost and management accounting is one of the core expenditure management functions of public financial management. It is required to maintain fund management operations, to provide management with up-to-date financial information and to maintain effective financial control.

This study unit focuses on the discussion of cost management in the public sector. However, before the core components of the application of cost management in the public sector are discussed, the study unit gives a conceptual analysis of first – cost, cost objects and cost management, and secondly, cost accumulation and assignment.

## 2 COST

There is no single accepted definition for the concepts cost and cost management for both public and private institutions. To public institutions, reference to cost and cost management is necessitated by the state of limited resources at their disposal. Public institutions always receive insufficient resources much less than they usually request. Insufficient resources are allocated despite the host of activities that public institutions have to perform. This experience makes it necessary that alternative methods of meeting the expectations be explored. Costing in public institutions is an important element of expenditure management. **Cost** is defined as a resource or a monetary amount that must be paid to acquire goods and services.



### 2.1 Cost objects

Managers often require information about the cost of the item to be able to make an informed decision. This is known as a **cost object** and is defined as an item for which a separate measurement of cost is desired. Examples of cost objects may include a product such as a state vehicle; a service rendered by a private service provider such as fitting new tyres or mechanical service on state vehicles; an activity or a programme that will be conducted by a public institution. An example of a programme might be an extended public service programme to create jobs and major investments in public infrastructure.



### ACTIVITY

Describe a cost object and list at least three examples.




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## 2.2 Cost management

Cost management refers to the processes by which a public institution, through a series of accounting procedures, report and monitor the expenses it incurs. It is used by public managers in public institutions to control and plan the costs of delivering services to communities. For example, before a project commences, the anticipated costs should be identified and measured. These expenses should then be approved beforehand. It is also important that during the process of completing a project, all incurred costs should be noted and kept on record to help ensure that the costs are controlled and kept in line with initial expectations, to the extent that this is possible. Taking this approach to cost management helps public institutions to determine whether they accurately estimated expenses at first, and will help them more closely predict expenses in the future. Any overspending can also be monitored in this way, and either eliminated in future projects or specifically approved if the expense was necessary. Cost management cannot be used in isolation; it is important that projects be organised and tailored with this strategy in mind.

## 2.3 Cost accumulation and cost assignment

Cost accumulation refers to the manner in which costs are collected and identified with specific processes. A costing system accumulates costs by some 'natural' classification such as materials, labour, fuel, advertising or transport. Cost accumulation is the collection of cost in an organised way through an accounting system. Cost assignment refers to a process by which cost is attached to activities. It is a general term that encompasses both (1) tracing accumulated cost to an object and (2) allocating accumulated cost to a cost object.

As described below, **direct costs** are those costs traced to a cost object, and **indirect costs** are those costs allocated to a cost object.

Virtually all systems accumulate actual costs, which are the costs incurred (historical costs) as distinguished from predicted or forecasted costs.

## 2.4 Cost classification

To determine the cost of goods manufactured in a manufacturing enterprise, you need to know which costs are **product costs** in such an enterprise. You also need to have an understanding of the flow of costs through the accounts of a manufacturing enterprise.

Product manufacturing costs consist of the following **three elements** (Du Plessis, Van Vuuren & Faul 1992:10):

- direct material
- direct labour
- manufacturing overheads

A major question concerning costs is whether they have a direct or an indirect relationship to a particular cost object.

- Direct costs of a cost object refer to costs that are related to the cost object and can be traced to it in a way that is economically feasible (ie cost-effective).
- Indirect costs of a cost object refer to costs that are related to the cost object but cannot be traced to it in an economically feasible way. Indirect costs are allocated to the cost object using a cost allocation method.



### Let us first define the different costs.

- **Direct material** consists mainly of primary material. It usually forms an integral part of the end product and is usually in predetermined, measurable quantities proportional to the volume of the production usage. Direct material forms a cost element on its own.
- **Indirect material** consists mainly of secondary material. It does not form part of the end product and the quantity used is not directly related to the volume of production. Indirect material does not form a cost element on its own and is normally grouped under **manufacturing overheads**.



To illustrate the **difference** between **direct** and **indirect material** the use of wood and sandpaper in a furniture factory can be taken as an example. The quantity of wood required for the manufacture of a specific piece of furniture can be determined accurately beforehand. However, the quantity of sandpaper used depends on the quality of the wood and can vary from piece to piece. Further, the sandpaper does not form part of the final product and consequently it is classified as indirect material.



Similarly, the concept **direct labour** refers to the cost of all essential labour physically expended on the manufacture of a product. In this case, too, it will not be possible to attribute certain labour costs incurred during the manufacturing process directly to a particular unit (or group of units). For example, the wages of welders who work in the manufacturing process would be classified as direct labour. On the other hand, the wages of machine maintenance personnel would not be classified as such but rather as **indirect labour** costs, which are classified under manufacturing overheads.

**Manufacturing overheads** refer to all the other costs necessary for the continuation of the manufacturing process, excluding direct material and direct labour. Examples of manufacturing overheads are indirect material and indirect labour (to which reference has already been made), the depreciation and insurance costs of production machinery and equipment, and so on. The primary characteristic of manufacturing overheads is that they cannot be attributed directly to a particular unit, but they are, in fact, incurred during the course of the production process. (Manufacturing overheads will be elaborated on later in this unit.)

## 2.5 Primary product costs and conversion costs

Two further subclassifications of production costs are:

- primary costs
- conversion costs

The concept **primary costs** refers to the total of the direct material and direct labour costs.

The concept **conversion costs** is still commonly used today and has a bearing on the total of the direct labour costs and manufacturing overheads. In this context the concept 'conversion' refers to the costs that must be incurred to convert raw materials to a finished product.

Bear in mind that the classification of costs into primary and conversion costs is not wholly exclusive. Total primary costs cannot, for example, be included in total conversion costs, because then the direct labour costs would be included twice.

Managers in both public and private organisations make use of different tools to access information that they use to make decisions. An example of such tools have seen the development of subsystems such as Management Information Systems (MIS), which basically processes financial transactions to provide:s

1. internal reporting to managers for use in planning and controlling current and future operations and for nonroutine decision-making
2. external reporting to outside stakeholders and other public institutions

The next discussion focuses on the need for accounting information.

## 3 THE NEED FOR ACCOUNTING INFORMATION

Public managers increasingly require relevant and timely accounting information in order to make correct and informed decisions. The changing nature of the economy and the consequent changes in the nature of the information that managers require inevitably influences the ways in which public managers measure costs.

### 3.1 The different fields of accounting

As public institutions expand and become more complex, their scope of work increases. In consequence, there is a far greater need for accounting information to determine financial results.

Accounting has developed in two streams – one to provide external users with financial information about the enterprise (financial accounting) and the

other to meet the requirements of the enterprise's management (management accounting).

**The purpose of financial accounting** is to make available financial information about the public institution by means of 'general purpose' financial statements (the income statement, balance sheet and source and application of funds statement) mainly for use by interested parties who do not take part in the day-to-day management of the public institution, in other words people and organisations who are themselves primarily **outside** the public institution.

These general purpose financial statements essentially provide a report of management's handling of the activities of the public institution for a limited, already expired period.

Management accounting concerns planning and control decisions. Examples of planning decisions are the following (Du Plessis et al 1992:4):

- What are the public institution's funding requirements in the short- and long-term?
- Should a given product or service be rendered, or is it more economical to purchase it from an outside supplier?

**Control decisions** require the comparison of actual results with expected results and the establishment of accountability for variances from the standards originally set. This function may require further management decisions to ensure that the planned results are achieved or to amend the initial planning in the light of the prevailing conditions.

The decisions that must be taken in the control phase are mainly choices between available alternative actions.

### 3.2 Cost accounting systems

A cost accounting system is a set of systematic processes and procedures that are used to measure, record and report on cost accounting data. There are five distinct activities in any cost accounting system: cost determination, cost recording, cost analysis, cost management, and cost reporting.



- **Cost determination:** In this activity, data are collected to determine the costs of a specific product or activity. Before this can be done, information (such as hours worked, material used and units produced) must be obtained from the different departments in the enterprise.
- **Cost recording:** Most cost accounting systems are an integral part of the enterprise's double-entry accounting system. The information for recording labour and material costs is obtained from various source documents such as wage sheets, suppliers' invoices, and so forth.

- **Cost analysis:** A cost accounting system can provide a large amount of information, but in order to be useful and meaningful it must be analysed by people who have a thorough knowledge of the cost accounting methods in use.
- **Cost management:** The cost accountant uses cost analysis to make meaningful recommendations concerning cost management (for example, savings on costs). The cost accountant thus fulfils a strategic role in the allocation of scarce resources within the organisation. To provide management with meaningful information, accountants must collect, analyse and report costing information in a manner that differs from the traditional ways. The techniques used for this will be discussed later.
- **Cost reporting:** Reporting is the process by which relevant information is given to the decisionmakers. Internal cost reports are usually very detailed. The cost accounting system as a whole must provide relevant and necessary information in good time to those who require it.

Du Plessis et al (1992:5) note the following:

**Cost accounting** emphasises the **assimilation** and **evaluation** of cost data. **Management accounting** emphasises the **use** of cost data in internal planning, control and special decisions.

## 4 LABOUR COSTS AND CONTROL

Du Plessis et al (1992:31) write as follows:

For the efficient control of labour costs some or other **norm** or **standard** must be set against which the efficiency of labour can be measured and which can serve as a basis for quantifying the difference between the expected norm (standard) and the actual output.

### 4.1 Labour control

Basically labour is controlled mainly by a comparison of:

- **what must be done and the labour time allowed for it with**
- **what is done and the labour time taken to do it.**

This gives rise to the important requirement for any labour control system, namely the gathering and recording of data for the calculation of the actual labour costs and time, which are used partially as a basis for the calculation of the standard labour costs and time.



## 4.2 Remuneration

A fair wage is one of the requirements laid down by the employee. The emoluments that an employee receives depend on the type of work that he or she performs, the degree of skill that is required for the specific work, the quality of the work that he/she does and, as with so many other facets of economic life, supply and demand.

The following are the methods of remuneration used:

- **Fixed salary method.** According to this method the employee receives a fixed salary irrespective of the quantity of work that he/she does or the time that it takes. This form of compensation is found in administrative and supervisory functions especially, and has the disadvantage that it bears no relation to the employee's output or the number of hours worked.
- **Hourly wages.** Here the worker is remunerated in accordance with the number of hours that he/she works. The disadvantage of this method is that it does not keep pace with the employee's output, but it is advantageous in that it pays only for the number of hours that the employee is present.

Calculation:

$$\text{Hours worked} \times \text{Rate per hour} = \text{Gross remuneration}$$

- **Piecework.** The employee is paid for the work that he/she does and not according to the time it takes him/her. This method can be used only where each employee's output can be determined precisely. It is advantageous to the employer in that he pays only for what is done.

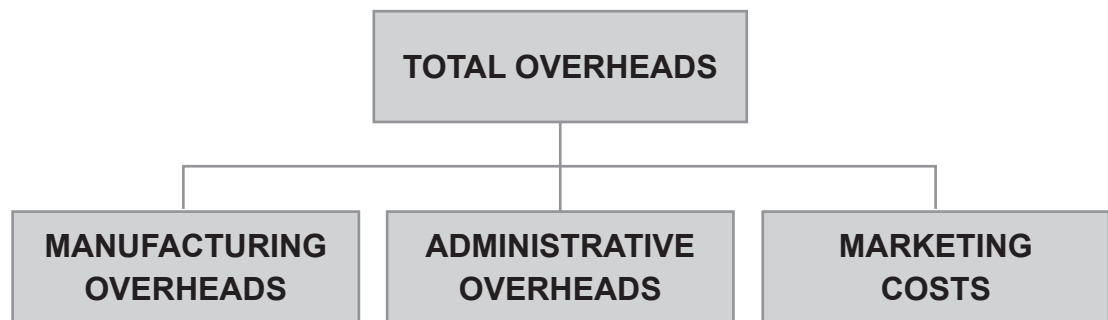
Calculation:

$$\text{Units manufactured} \times \text{Rate per unit} = \text{Gross remuneration}$$

Various methods of combining hourly wages, piecework and fixed salaries have already been developed with the aim of utilising the advantages of each system and eliminating the disadvantages. Thus the employee receives a minimum hourly wage which increases as his output increases in accordance with piecework, with a minimum guaranteed fixed salary.

## 5 CALCULATIONS OF MANUFACTURING OVERHEADS

Overheads, the third cost element to be discussed, can be subdivided as follows:



Overheads include all the costs which are necessary for the enterprise's activities but which cannot be allocated to the two cost elements already discussed, namely material and labour.

**Manufacturing overheads** can be summarised as all the manufacturing costs necessary for the efficient continuation of the manufacturing process, excluding direct material and direct labour which are shown as separate cost elements, and thus constitutes the third element of total manufacturing costs.

Direct material + Direct labour + Manufacturing overheads  
= Total manufacturing costs.

Overheads are of such a size that no manufacturing concern can afford not to control them properly.

The importance and volume of manufacturing overheads have increased since mechanisation and automation gained prominence as the most important features of the modern manufacturing set-up. The following cost items are classified as manufacturing overheads:

- the cost attached to leasing factory premises
- the cost attached to the maintenance of machinery and equipment
- depreciation
- supervision
- quality control

### 5.1 Cost price calculation and manufacturing overheads

The apportionment of manufacturing overheads to the various products manufactured is the single largest problem with regards to cost calculation.

The cost of direct material used in the manufacture of a product can easily be calculated from the material requisitions. Labour costs can be determined reasonably accurately from the clock cards. Manufacturing overheads, however, are not so easily determined.

In earlier times manufacturing overheads were calculated on a historical basis. The sum total of the manufacturing overheads for a certain period, usually a day or week, was divided by the number of units manufactured during that period to give the overheads per unit.

However, due to the administrative workload and the greater extent of modern production facilities, it is no longer practical to prepare statements on a daily or weekly basis in order to determine the figure. To aggravate the complexity of the problem, the information is also no longer so easily collectable. Think of the cost of power, where electricity usage is calculated on a monthly basis and the enterprise is informed of the cost a few weeks after the end of the month. Also, diversification has ensured that an enterprise seldom manufactures only one product, as was the case in the past, but usually manufactures a series of products simultaneously. All these factors have contributed to the calculation of unit costs and cost prices on a historical cost basis becoming obsolete and falling into disuse.

A new method had to be found to bring manufacturing overheads into account in determining the cost. **These days the cost is allocated on the basis of the causal relationship between the products.** Here the cause (cost) is linked to the effect (the product), and vice versa. But this division is also very difficult, especially in enterprises which manufacture heterogeneous products in different departments.

## 5.2 Classification and analysis of overheads

In order to divide the manufacturing overheads by means of the causal relationship which exists between costs and products, an analysis and classification of the overheads is necessary.

The most important **classification** of manufacturing overheads is according to their fixed and variable characteristics:

- fixed manufacturing overheads
- variable manufacturing overheads
- semi-fixed manufacturing overheads
- semi-variable manufacturing overheads

### 5.2.1 Fixed manufacturing overheads

**Fixed manufacturing overheads** are costs that are constant in total for a certain period and are not linked to the number of units manufactured during that period. They can also be viewed as the costs that are incurred to establish the capacity (manufacturing facility), that is to say the costs of being in business. An example is the hire (ie lease) of a factory location, a fixed amount per annum irrespective of the number of units manufactured during the year.

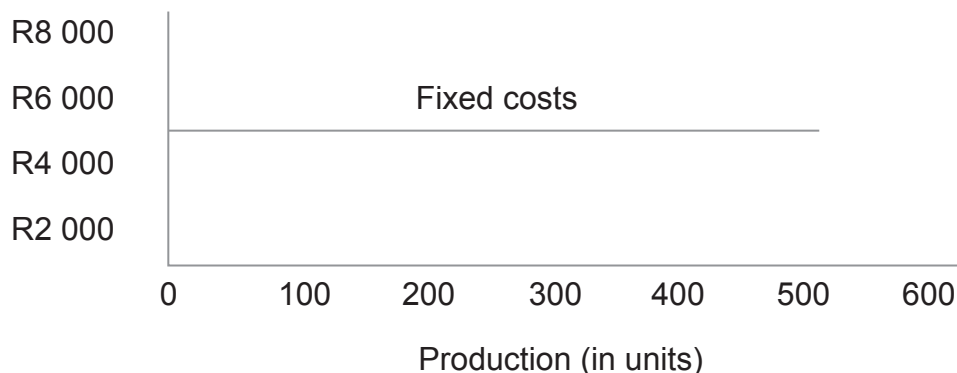
A very important fact is that the cost is fixed in total, but if it is calculated per unit it decreases as long as the number of units increases.



### Example

	100 units	500 units
Total hire per annum	R6 000	R6 000
Hire per unit per annum	R60	R12

### Graphic representation



The hire remains **constant in total** as R6 000 per annum and does not vary with the volume of production. The cost per unit produced decreases as the volume of the production increases.

Fixed costs are fixed for a **given capacity level** and **period** only. This capacity level, usually indicated by minimum and maximum limits, is known as the **relevant range** within which the fixed costs will not change. If the manufacturing capacity is expanded to a level outside the relevant range, the total amount of fixed costs will also increase.

### 5.2.2 Variable manufacturing overheads

**Variable manufacturing overheads (sometimes also called direct overheads)** have characteristics opposite to those of fixed manufacturing overheads. These are incurred in the utilisation of the available capacity, that is to say they are the cost of **doing business**.

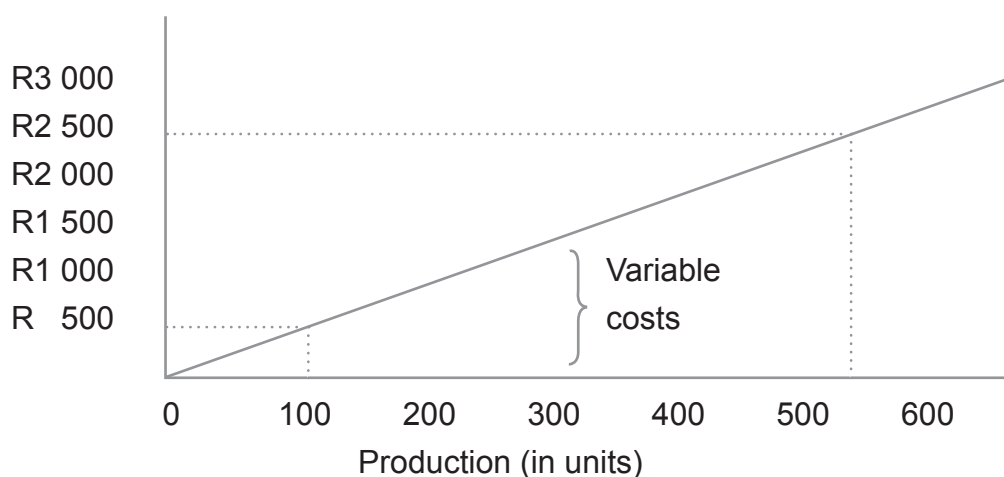
Variable costs have a direct bond with and vary directly in relation to the volume of production, because the cost per unit produced is constant.



### Example

	100 units	500 units
Variable manufacturing overheads per unit	R6 000	R6 000
Total variable manufacturing overheads	R60	R12

### Graphic representation

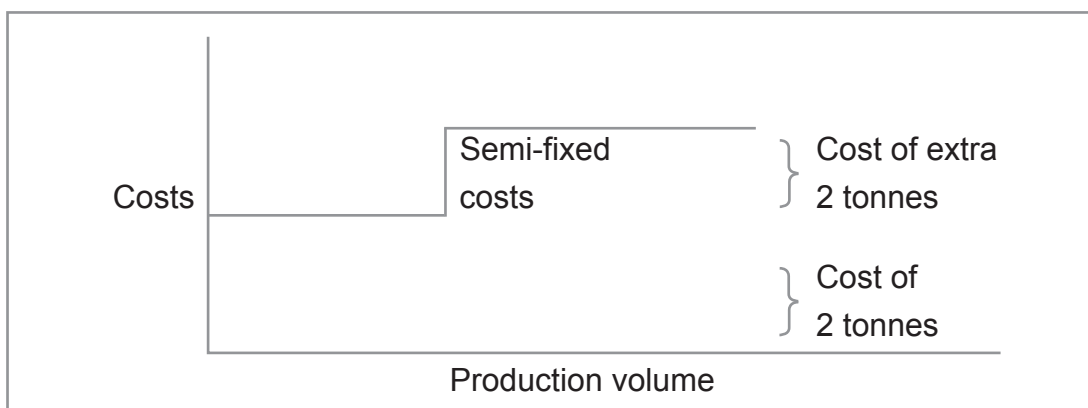


### 5.2.3 Semi-fixed and semi-variable manufacturing overheads

**These overheads** have both a variable and a fixed element. Transport can be taken as an example of semi-fixed costs. A truck with a capacity of 2 tonnes can transport a certain number of units. Increase the load to more than 2 tonnes and either a bigger truck must be acquired or two journeys must be made. The costs thus increase by degrees in proportion to the production volume increase.



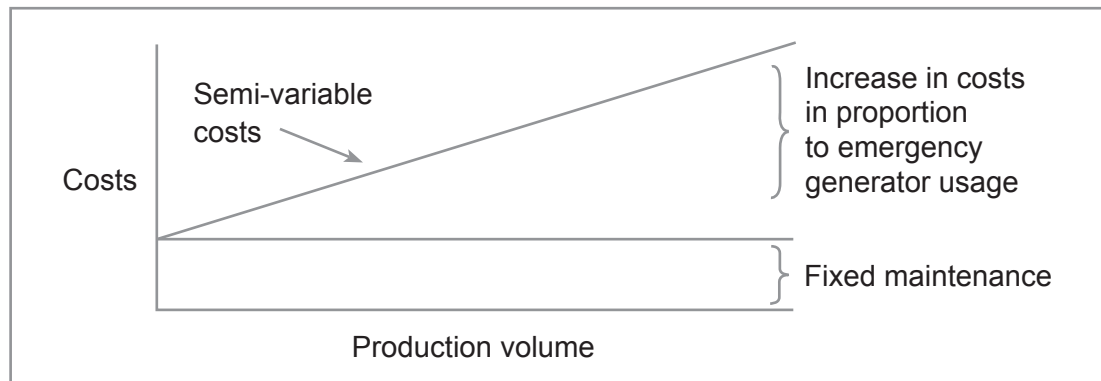
### Example



The cost of an emergency generator is a good example of **semi-variable manufacturing overheads**. Fixed monthly maintenance is a certain amount, but whenever it is used provision must also be made for petrol costs.



### Example



Since there is little difference in handling and controlling semi-fixed and semi-variable manufacturing overheads, no further distinction will be made between these two cost types, and it is accepted that what is applicable to one is also applicable to the other.

### 5.3 Total manufacturing overheads and the linear function

Because a constant variable cost per unit is accepted in costing, as a consequence it also has a **linear total cost function**.

In general the linear function evolves from a series of observations of activity levels and the related cost. Thus it can be depicted algebraically by means of the following formula for a linear function:

$$T = a + bx$$

where  $t$  = total manufacturing overheads

$a$  = fixed costs (including the fixed portion of semi-variable costs)

$b$  = variable costs (including the variable portion of semi-variable costs)

$x$  = volume in units

### 5.4 Dividing overheads

The division of manufacturing overheads into fixed and variable elements has great advantages for control purposes.

The amount of fixed manufacturing overheads is relatively easily **controllable because the total amount is constant**. If the amount is exceeded there is wastage or ineffective employment of funds and the cause can be determined.

The amount of variable manufacturing overheads is also easily **controllable because the cost per unit is constant**. The costs per unit multiplied by the number of units manufactured gives the total variable manufacturing overheads, which can be used to determine whether there is any wastage or whether ineffective usage has taken place.

Some types of manufacturing overheads can easily be divided into their fixed and variable elements, but with others this is impossible unless one of the following **techniques** is used:

- regression analysis
- high-low method
- simple regression
- multiple regression

#### 5.4.1 Regression analysis

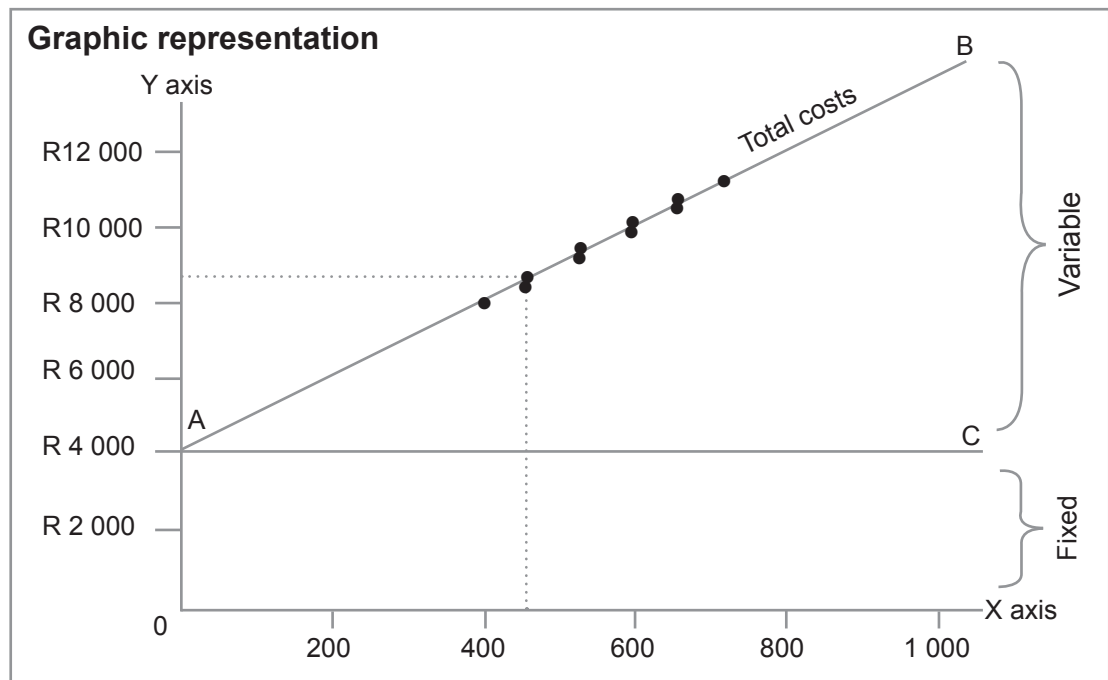
Regression analysis can be applied by preparing a scatter diagram of different observations of volume on one side with the associated costs in respect of the various volumes on the other side. (Graphically the volume is shown on the X axis and the cost on the Y axis.)

Thus, by drawing a comparison between the volume of production on the one hand and the manufacturing overheads on the other, the tendency between the fixed and variable elements can be traced.



#### Example

Month	No. of units manufactured	Total manufacturing overheads R
January	450	8 600
February	600	10 200
March	700	11 000
April	650	10 300
May	600	10 100
June	550	9 600
July	550	9 300
August	500	8 800
September	500	9 100
October	450	8 600
November	450	8 400
December	400	8 000



By drawing a straight line (AB) through the various points, as indicated, and by connecting it to the Y axis (A) and then drawing a straight line parallel to the X axis from the intersection (A), we get a graphic representation of the fixed and variable elements of the total manufacturing overheads.

In this case line AC represents the fixed overheads (R4 000) and AB the total manufacturing overheads. The variable overheads are represented by the area between lines AB and AC. By dividing the variable costs by the number of units the variable cost per unit (R10) is obtained.

However, this method is not very accurate, since everyone will draw the line AB with a different gradient through the various points. The division between fixed and variable will therefore differ, but should provide adequate information for control purposes.

#### 5.4.2 High–low method

This method is basically the same as regression analysis except that it takes only the highest and lowest volumes into consideration. The advantage of this method, although it is not as accurate as the others, is that it is quick and easy to make the distinction.





### Example

Month	No. of units manufactured	Total manufacturing overheads R
January	450	8 600
February	600	10 200
March	700	11 000
April	650	10 300
May	600	10 100
June	550	9 600
July	550	9 300
August	500	8 800
September	500	9 100
October	450	8 600
November	450	8 400
December	400	8 000

	Volume	Manufacturing overheads
Highest	700	R11 000
Lowest	<u>400</u>	R 8 000
Difference	<u>300</u>	R 3 000

As a starting point the principle that fixed costs are constant in total and do not vary with the production volume is used. Thus the increase in manufacturing overheads (R3 000) is attributable to the variable element and the manufacture of the 300 extra units. Variable manufacturing overheads thus amount to R10 per unit, or R3 000 divided by 300 units. The fixed costs can now be calculated as follows:

	Total overheads R	Variable R	Fixed R
Highest	11 000	7 000 *	4 000
Lowest	8 000	4 000	4 000
* 700 × R10 = R7 000			

If the costs of the highest and lowest volumes show abnormality, for example exceptionally low costs compared with the highest volume, the high-low method cannot be used for the division as it will show an unrealistic amount for the fixed costs.

### **5.4.3 Simple regression**

Regression analysis is described as a technique for drawing a straight line through a given quantity of observations.

In contrast with the scatter profile, where the line is drawn according to the judgement of the person who prepares it, it can also be determined with mathematical precision by means of a technique known as simple regression (the least squared method). Simple regression is the development of an equation which indicates the relationship between one fixed and one variable factor.

Just as the total manufacturing overheads in the previous three methods can be divided between the fixed and variable elements, so each individual cost element can also be divided into its fixed and variable components.

For control purposes it is necessary that overheads are divided. It is also an important aid for pre-planning and for the preparation of budgets.

## **6 CONCLUSION**

It should be evident that the need for cost and management accounting arises from the requirements of proper and effective financial management in the public sector. It should also be evident that financial managers should have a thorough knowledge of all the aspects related to cost and management accounting in the public sector.

Costs are related to all government functions and services. In order to maintain effective and essentially sound economic management of the public sector, costs need to be kept as low as possible. In order to do this, cost management should be exercised just as stringently as all the other financial management functions.

Even public entities, whether state departments or parastatals, need to limit their operating costs to what is essential. In providing public services and functions, certain operating costs have to be incurred. Service delivery will be influenced by the extent to which operating costs can be recovered, since savings on overheads can result in the availability of surplus funds.

The financial management reform in South Africa also intends providing managers at all levels with the opportunity to effect such savings, instead of merely spending in terms of what has been budgeted for. Manufacturing overheads is one area that managers could perhaps manage more dynamically if savings are to be generated.



## 7 SELF-ASSESSMENT

1. Explain the difference between financial accounting and management accounting. (3)
2. Describe the various types of cost accounting systems. (20)

## 8 FEEDBACK ON SELF-ASSESSMENT

1. Accounting has developed in two streams – one to provide external users with financial information about the enterprise (financial accounting) and the other to meet the requirements of the enterprise's management (management accounting).
2.
  - **Cost determination:** In this activity, data are collected to determine the costs of a specific product or action. Before this can be done, information (such as hours worked, material used and units produced) must be obtained from the different departments in the enterprise.
  - **Cost recording:** Most cost accounting systems are an integral part of the enterprise's double-entry accounting system. The information for recording of labour and material costs is obtained from various source documents such as wage sheets, suppliers' invoices, and so forth.
  - **Cost analysis:** A cost accounting system can provide a large amount of information, but in order to be useful and meaningful it must be analysed by people who have a thorough knowledge of the cost accounting methods in use.
  - **Cost management:** The cost accountant uses cost analysis to make meaningful recommendations concerning cost management (for example, savings on costs). The cost accountant thus fulfils a strategic role in the allocation of scarce resources within the organisation. To provide management with meaningful information, accountants must collect, analyse and report costing information in a manner that differs from the traditional ways.
  - **Cost reporting:** Reporting is the process by which relevant information is given to the decisionmakers. Internal cost reports are usually very detailed.

The cost accounting system must as a whole provide relevant and necessary information in good time to those who require it. Cost accounting emphasises the assimilation and evaluation of cost data. Management accounting emphasises the use of cost data in internal planning, control and decisionmaking.

Different meanings can be attached to the term 'cost data':

- the allocation of costs between cost of sales and finished goods stock for the calculation of profit
- cost data for long- and short-term decisions
- cost data for planning and control decisions

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# FINANCIAL PLANNING BASED ON THE MTEF

UNIT

4

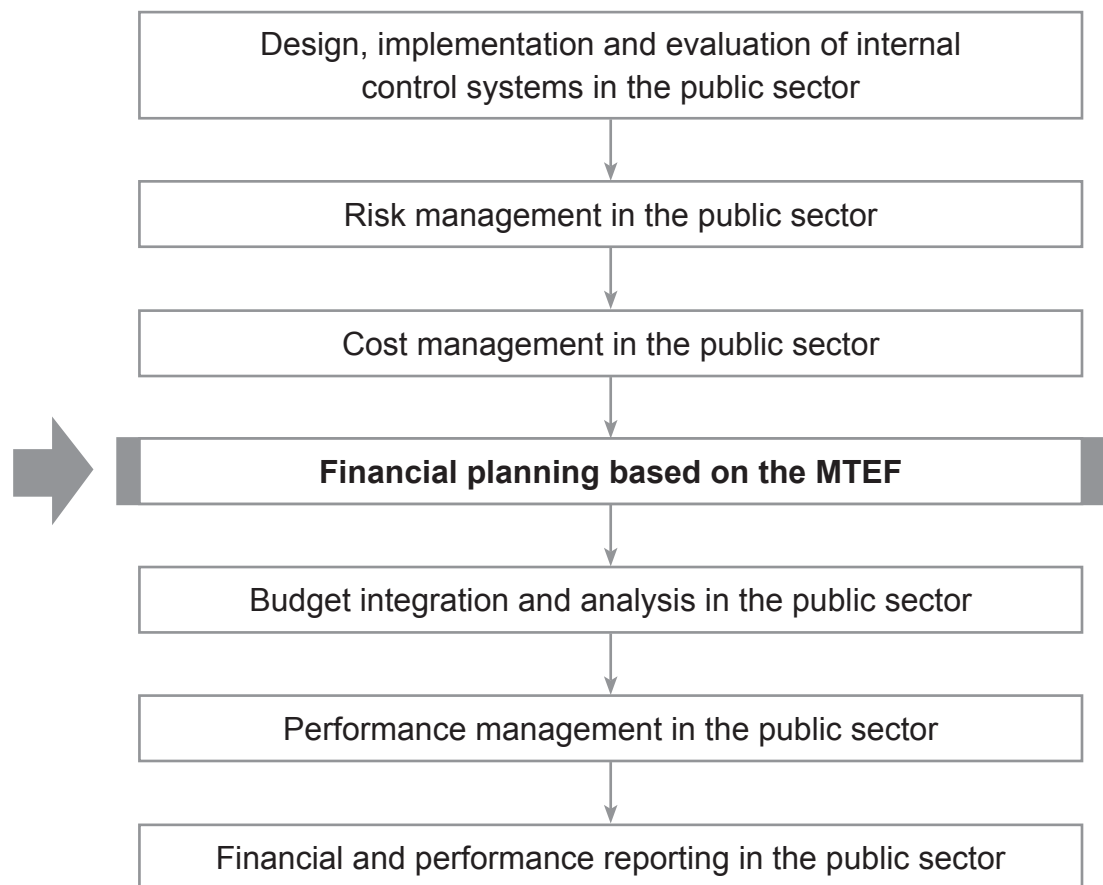
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## ROUTE MAP

Use the route map below to determine where you are within the syllabus and where this study unit fits into the module:



## LEARNING OBJECTIVES

After studying this unit, you should be able to:

- apply the principles and practices of short-term planning
- integrate short-term planning into medium-term plans

## 1 INTRODUCTION

Public sector institutions in most countries are designing and testing new development and planning interventions as part of their modernisation efforts. Medium-term financial planning has become one of the fundamental features of ongoing public sector management reform. As with many African countries, the use of medium-term financial planning in South Africa is fairly new and has been brought in to complement the transformation process of public sector institutions, especially on matters relating to the management of public finances. In terms of South Africa's legislative frameworks and a whole range of regulations and guidelines, notably those provided by the National Treasury, public institutions need to plan their business over the short, medium and long term in order to cope with the service delivery challenges they are faced with.

This study unit provides the discussion of financial planning and highlights the implementation of the Medium Term Expenditure Framework (MTEF) in South Africa as a framework. The first part describes financial planning perspectives in general, whilst the second focuses on various dimensions of financial planning. The third explores direct links that exists between short and medium-term planning in the public sector. This link is disconnected by the discussions that focus explicitly on short-term financial planning and medium-term financial planning in the public sector. The sixth part pays attention to South Africa's MTEF and highlights various aspects of the MTEF. These aspects include the implementation and evaluation of the MTEF and budget, the basic principles of the MTEF, the outputs of the MTEF process and key decision stages that makes up the MTEF process. The discussion of the reconciliation of MTEF and departmental spending plans concludes the discussions in the study unit.

## 2 FINANCIAL PLANNING PERSPECTIVES

Financial planning in general relates to determining objectives and associating them with the costs. This implies that financial planning is a functional activity

undertaken by each individual, household and type of institution. The only differences between them would concern the format, extent, monetary value and objectives of the planning.

Simply stated, any household needs to do financial planning. The reason for household financial planning is that households earn a particular income, generally monthly, and the households do financial planning in terms of their disposable income and what they need to do with this income. The extent of their choice is limited by the amount of income at their disposal. The type of financial planning and its format invariably differ from household to household, owing to personal preferences and choice. The reason why households need to do financial planning is to ensure that their expenditures do not exceed their income. Financial planning in households is therefore generally quite basic and informal, designed and exercised for the particular household requirements.

Formal institutions of any type also need to do financial planning but for a host of different reasons from households. In respect of formal institutions, we can distinguish between types that are profit-making and types that are not. The reason for this distinction is that financial planning is done differently in the two types.

This distinction also serves to characterise private sector institutions versus public sector institutions. This does not mean that all private sector organisations are necessarily oriented to making a profit. Examples are the Salvation Army and the SPCA, neither of which exists to make profit or falls within the broad government sector.

We can conclude, therefore, that financial planning is a functional activity performed by individuals, households, the private sector and the public sector. Financial planning in all cases covers more or less the same areas (such as monetary value, type of objective, scope and dimension) and generally has the same purpose.



### ACTIVITY

*State in your own words what you understand by the concept of financial planning.*

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### 3 DIMENSIONS OF FINANCIAL PLANNING

What does financial planning consist of, and how does one go about doing financial planning? To answer these questions there is a need to look at the various dimensions of financial planning. For the purpose of this section we do not distinguish between the private and public sectors. The various dimensions will therefore be of a generic nature.

#### 3.1 Functional objectives

The objectives on which financial planning is based should be functional. This means they should achieve determined results that can be physically ascertained, such as particular products or profits. Identifying non-functional objectives would be a complete waste of time. Therefore, planning needs to identify specific outcomes to be achieved.

Financial planning is conducted according to these objectives. Of course, there may be financial planning that is based on less determinate, preliminary objectives, but this would be for another purpose – such as a viability study to determine whether a project or objective is viable.

#### 3.2 Future planning

Financial planning invariably includes plans for the future. Since financial planning intends to identify the costs associated with achievable outcomes, it is by implication directed towards the future. The timescale for various households, institutions and individuals differs substantially.

Households do financial planning on a monthly basis, such as deciding how much to spend on clothes, dining out, gardening equipment and so forth. Households, however, also purchase motor vehicles from time to time, or buy a new house. Generally households cannot afford to purchase a motor vehicle with a particular month's salary, which means they need to obtain loans to purchase a car and then repay the financing institution over a period of three to four years. Housing loans take between 20 and 30 years to repay. Both of these transactions are of various terms, and both influence the short-term financial planning of households. When doing their monthly financial planning, households need to take their longer-term financial commitments into consideration.

The same principle applies to formal institutions. Those in both the private sector and the public sector do financial planning over the short and longer terms. Such financial planning is also directed at the future, in other words at what they want to achieve within a specified period such as the next quarter of the year, next year or the next five years.

It needs to be emphasised that time must be allocated to execute what is planned. In other words, financial planning cannot continue indefinitely. The scheduled process through which the planned objectives are to be achieved must be activated. If this is not done, financial planning has no reason for being undertaken.

Normally institutions plan their activities for one year into the future. This implies that in a current year the objectives set the previous year are being pursued, while in the same year the objectives for the next year are being planned. In this sense, planning and execution run concurrently with each other, one being directed at the current year (execution) and the other at the ensuing year (planning).

Not all objectives can be achieved in a single year; therefore financial planning is also directed at the medium and longer term. For the sake of clarification, the timescale differences are generally regarded as being as follows:

- **Short term:** This is normally one year in formal institutions. For financial and accounting purposes this is known as a "financial year" or a "book year". In the private sector no year-end date is prescribed, which means a company can decide when it wants its financial year to start and when the year end should be. The rule is 12 months, which means that the start of the financial year automatically denotes what the year-end date will be. It is important to consider the start of the financial year for the purpose of financial planning, because planned objectives for the short term should not exceed 12 months. In the public sector the date of the new financial or book year is determined by legislation. The time-frame is 12 months, starting on 1 April and ending on 31 March of the ensuing year.

- **Medium term:** The medium term can be anything between three and five years. The purpose of financial planning over these periods is necessary to determine the financial needs (and possibly constraints) for a particular period into the future, importantly with a fixed starting date. This is particularly with regard to developmental or capital projects, or projects where the ultimate objective cannot be achieved without first achieving other intermediate objectives. Examples of such ventures are numerous, such as road construction, stormwater drainage systems, land purchases (by government), community development programmes, extension of communication networks or creation of employment schemes.
- **Long term:** Long-term financial planning comprises financial planning aimed at achieving objectives for a period of five years or more. Government's debt repayment programmes for a particular loan could be upwards of 10 or 20 years in duration.

### 3.3 Scarcity of resources

One of the most basic reasons for financial planning is that it is an intervention with which available resources are utilised considering the intended objectives. The scarcity factor with regard to households is related to their income level. In other words, the financial planning of households is limited to their income per month.

In the private and public sectors, ever-present scarcity is the main factor necessitating financial planning. The scarcity of production factors such as raw material, money and personnel forces institutions to plan their objectives according to the consequent constraints. Financial planning serves as a means of devising the best plan of action, with due consideration of all constraints and other relevant factors that may influence the financial plan either adversely or supportively.

The scarcity factor influences financial planning so significantly because, when resources are scarce, planning cannot freely proceed on the basis of the desired objectives, as it can do when resources are abundant. Of course, an ideal situation of unlimited resources and unconstrained financial planning does not exist in practice, neither for the private sector nor for the government. Both types of institution exist in an environment where they must compete with each other for resources, the availability of which is normally less than desired.

### 3.4 Formalised financial planning

It should be realised that financial planning is not an isolated element within any formal structure. We use the term "formal structure" to denote any type of enterprise, business concern or public institution that uses some form of financial

planning as part of the process of conducting its business. This “business” could involve constructing motor vehicles, selling fast food, providing water and electricity or paying pensions to elderly or disabled people. To do any of these things and ensure that intended objectives are achieved, some type of financial planning has to be done. However, in the environment we live in today there are a multitude of factors that influence financial planning directly or indirectly. Consequently, for financial planning to provide a proper basis for achieving objectives, it must be structured in a particular way.

Structuring financial planning according to a predetermined format prevents haphazard, ad hoc and uninformed decisionmaking that would lead to pursuing objectives that are wrong, tangential, unrealistic, too expensive or misdirected. Since financial planning needs to be as accurate as possible to ensure the success of the venture and utilise scarce resources optimally, it needs to be done according to a structure that works. With this in mind, financial planning generally adheres to a particular route or structure that entails the following elements:

- Identifying objectives – this can be done by the board of a private firm or by the Cabinet in the case of the public sector.
- Aligning the objectives in terms of a strategic plan (not business plan, because the financial plan is part of the business plan).
- Dividing objectives in terms of identifying their constituent parts.
- Associating costs with each of the various subdivisions of the main objectives, to the lowest possible level, to prevent hidden costs from emerging only after the process of implementation has started.
- Working out alternative options to achieve objectives if the process of costing (or estimation) proves too expensive – any institution will generally have a good idea of the financial resources at its disposal (whether investment funds, savings, loans or taxation income in the case of the state) and this information serves as basic point of departure where estimation and costing is done as part of financial planning.
- Presenting the objectives and sub-objectives schematically, including the financial implications, source of funds, time-frames if required (for contracting purposes) and responsible persons (accounting officers, programme managers, regional managers) in each case.
- Using the schematic presentation to align with the business plan of the institution or operational plan, in order to obtain approval to spend the funds on the objectives as planned; in the case of the state, Parliament needs to authorise spending, whereas in the case of the private sector it could

be the managing director, board members or any form of authorisation pertaining to a particular institution.

These are merely the components of a more formally structured procedure for financial planning. In the case of the state, the exact procedure for financial planning is contained in legislation.

### 3.5 Comprehensive financial planning

Financial planning intends to identify all relevant factors with financial implications. This includes human resources planning, logistics, other resources (and their availability), equipment, telephones, computers, stores, transport, taxes, furniture, marketing, promotions and so forth. The actual financial planning serves only to consolidate the planning done in respect of the preceding elements. The person in charge of marketing, for instance, plans the marketing function of the institution or business enterprise, while the human resources officer plans the required personnel needs. The financial plan may be compiled by the firm's accountants in conjunction with departmental heads or managers of the various functional units in the organisation. This means the financial plan reflects the type and nature of business or institution. It is therefore not a narrow document pertaining to identified objectives and their financial implications but rather a comprehensive summary of the institution and its business.



#### ACTIVITY

*Indicate the elements of financial planning in the public sector. Explain which is the most vital element for comprehensive financial planning.*

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## 4 LINKING SHORT AND MEDIUM-TERM FINANCIAL PLANNING

It follows that there should be a link between short and longer-term financial planning. Given the future-directed nature of short and longer-term planning, it is obvious that short-term planning needs to be compatible with longer-term planning. If it is not, public institutions will have divergent goals. For instance, the objective of the Department of Foreign Affairs is to represent South Africa in foreign nations, which means that both its short and long-term objectives have to be aligned with this broad objective. The Department cannot have a short-term financial plan aiming at the representation function and a long-term plan having national security as its primary objective. Short-term financial planning should serve as a component of longer-term planning. The annual short-term objectives should complement the longer-term objectives, the latter being contained in a longer-term financial plan because they cannot be achieved in a single financial year or in the short term.

## 5 SHORT-TERM FINANCIAL PLANNING IN THE PUBLIC SECTOR

Simply put, financial planning in the public sector is nothing other than the annual budget process. The annual budget process of the state is the mechanism used to identify spending objectives, estimating the financial implications according to a cost-benefit analysis procedure in which financial constraints imposed by the relevant treasury are kept in mind and approval is sought from the legislature.

Budgeting in the public sector for short-term financial planning comprises the following steps:

- identifying activities
- defining the goals of the government and formulating missions
- examining the rationale for all activities
- discarding existing activities and establishing new activities
- costing activities based on the most economic, efficient and effective way of providing the service
- prioritising activities
- determining alternative planning options for a vote as a whole and their implications
- compiling a budget planning submission based on the above steps

The annual budget represents the government's short-term planning objectives for one financial year. The annual budget itself forms part of the financial planning process to be executed over a time-span of one year, and is therefore of short-term duration. The annual budget is the result of financial planning.

Although the annual budget is primarily planned and executed over the short term, it also contains elements of longer-term planning outcomes where relevant. To keep track of long-term goals effectively, another type of planning framework needs to be established whereby this function can be arranged – hence the existence of a longer-term planning system. Since the short-term financial plan should be linked to the longer-term plan in some way, the ideal situation is that any short-term financial plan should be the first year of the longer-term financial plan. In practical terms this can be illustrated as follows:

- budget 2005 – First year of five-year, medium-term plan starting in 2000 and ending at 2010
- budget 2006 – First year of five-year, medium-term plan starting in 2001 and ending at 2011
- budget 2007 – First year of five-year, medium-term plan starting in 2002 and ending at 2012

The most obvious impression from the schematic presentation is that the last year of a five-year medium-term financial plan shifts by one year as each consecutive budget year starts off. This is known as a rolling medium-term financial plan. However, before the link between short-term and medium-term financial plans is explained, there is a need to first identify the characteristics and objectives of medium-term financial planning and financial plans.



### ACTIVITY

*Briefly explain how annual spending programmes are associated with medium-term spending programmes.*

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## 6. MEDIUM-TERM FINANCIAL PLANNING IN THE PUBLIC SECTOR

Medium-term financial planning is not a new concept in expenditure management. Foreign countries and international agencies have ventured into this area of public financial management for some time. This concept was introduced relatively recently into the public sector. In 1995 a World Bank discussion paper on this topic offered valuable insight for research purposes. This discussion paper was published as a result of research conducted on the failure of governments to plan expenditures effectively in the light of severe fiscal constraints. These fiscal constraints were characterised by deficit budgeting and escalating debt burdens caused by arranging loans to redeem the interest on existing loans, with little or no possibility of capital redemption.

Therefore, governments required an analytical framework that would enable them to forecast programme spending over a three- to five-year period (adapted annually), taking account of both likely resource constraints and the link with the economy at large. Such a framework can be described as a medium-term expenditure plan and carries many of the virtues of the comprehensive planning approach to public finance. This framework would include:

- a macroeconomic framework that links public expenditure and revenue to other economic variables
- projections of the major items of current expenditure
- a multi-year, phased public investment programme distinguishing between high and lower priority projects
- projections of revenues from tax and non-tax sources as well as borrowing needs

From the above it can be deduced that annual budgets will not fit like a glove into any medium-term expenditure plan but will inevitably overlap certain areas of it. This is not coincidental but rather the result of serving differentiated needs and objectives. Annual budgeting, representing a short-term financial plan, can be associated with financial planning in a microperspective, while medium-term expenditure plans can be viewed as a more macro-oriented financial plan. A medium-term financial plan also provides a more holistic view or total picture of the longer term than is possible with a short-term financial plan.

A further distinction is that a short-term financial plan is that it addresses immediate objectives that have to be realised within a specific financial year, while medium-term financial plans have a longer, intermediate range. It is also of interest that although short-term financial plans serve as the constituent parts of a medium-term financial plan, the short-term financial plans are more a result of medium-term financial planning than the other way around.

## 6.1 The characteristics of a medium-term financial plan

The following are the characteristics of a medium-term financial plan (or medium-term expenditure plan). The medium-term financial plan is a:

- macroeconomic analysis linking the growth of national income, savings, investment and balance of payments to public expenditures and revenue (this is not possible with a short-term financial plan)
- rolling, multi-year public investment programme with phased outlays reviewed annually
- fiscal plan, which includes:
  - revenue forecasts at existing rates of taxation consistent with the macroeconomic assumptions
  - forecast of non-tax revenues (surplus of public enterprises, fees, user charges) based on macroeconomic projections but without any change in policy
  - estimation of additional revenues that may be mobilised by, for example, higher tax rates, a different tax structure or institutional and administrative reforms in tax collection
  - estimation of additional income resulting from changes in the policy framework for public enterprises, public sector pricing policy, changes in the social sector and so forth
  - estimates of resources available from domestic and external borrowing and grants
  - projections of current expenditure including debt servicing, defence, administration and recurrent expenditure on development (subdivided between committed and anticipated discretionary expenditures)



### ACTIVITY

*Return to the previous question. Decide whether you need to adapt your previous answer in terms of the subsection you have just completed, and indicate why you may need to do so.*

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## 6.2 The advantages of medium-term budgeting

Medium-term budgeting has four main advantages. These advantages are briefly described below.

- Through medium-term budgeting, there is increased certainty because policy priorities are set out in advance. The condition in which priorities are set in advance allows public institutions to plan and budget in line with policy priorities.
- With the medium-term budgeting public, institutions plan and spend on 3-year programmes, which makes spending more affordable.
- Political decisionmaking and accountability are strengthened.
- There is also improved management of public finances since government's medium-term fiscal targets, tax policy and debt management can be linked to spending commitments.

## 7 SOUTH AFRICA'S 'MEDIUM TERM EXPENDITURE FRAMEWORK' (MTEF)

According to Le Houerou and Taliencio (2002:8), the Medium Term Expenditure Framework was introduced in 1997 for the period 1998/99 to 2000/01 in South Africa. The framework is based on a three-year period.

It is a tool for linking policy, planning and budgeting over a medium-term period and consists of a top-down resource envelope and a bottom-up estimation of the current and medium-term costs of existing policies. The MTEF matches the costs of policies with available resources in the context of an annual budget process and provides a mechanism for allocating funds to various sectors. It assists in the revision of performance targets and serves as a basis for holding national and provincial departments to account in a results-based management framework.

### 7.1 The purpose of the MTEF

The purpose of the MTEF is to:

- ensure that there is a co-operative process for reviewing and analysing national and provincial budget submissions and preparing a consolidated expenditure framework which is consistent with the government's social, economic and development policies
- assess the financial resources that will be required to implement the programmes and activities to achieve the goals and targets.

- ensure that funding is available as and when needed
- to monitor the efficient use of resources and of progress towards achieving the goals and targets

## **7.2 Key objectives of the MTEF**

The key objective of the MTEF is to ensure that the government is able to deliver its reconstruction and development priorities in the context of three-year estimates of expenditure that are consistent with the macroeconomic framework. The MTEF is intended to enhance the transparency of the budget process and budget documentation so that policy goals and resource allocations are clearly set out, thereby enabling budgets to be prioritised.

The benefits of a medium-term expenditure framework are that it:

- enables public institutions and spending agencies to consider how best to deliver public services and transformation within realistic projections of their budgets
- establishes a framework for assessing new policy proposals
- fosters medium-term planning by spending agencies
- allows public institutions and spending agencies to enter into forward commitments without requiring rollovers of unspent prior allocations
- improves the credibility of fiscal policy

The MTEF evolves each year. The baseline of each year's MTEF is the previous year's forward estimates. Over time, adjustments to estimates occur only as a result of identified changes in policy or circumstances. The MTEF in South Africa represents an opportunity to analyse public expenditure trends and pressures.

## **7.3 Outputs of the MTEF process**

In terms of an analysis of the treasury guidelines, several outputs can be associated to the MTEF process. The significance of the outcomes to the medium term is also highlighted in the discussions of the basic principles of the MTEF and the key decision stages of the budgeting process. For the purpose of the discussion in this study unit, five major outputs are identified and briefly discussed.

### **7.3.1 Cabinet analysis**

Cabinet analysis as an output of the MTEF process entails that the Cabinet forms part of an array of participants in the determination and funding of policy priorities of public institutions. This means that during the budget MTEF process, the Cabinet, after it has analysed available information on policy priorities and budgetary constraints, decides on policy alternatives that will be pursued during the implementation period.

### ***7.3.2 Identification of policy variables***

The MTEF process identifies key variables that are associated with programme costs and outcomes. The MTEF process as is core, is a tool that provides better information to enable the identification of trade-offs between competing policy priorities.

### ***7.3.3 Improved programme or departmental structure and budget***

A programme structure and organisation structure of public institutions should be aligned to the budget. This means that when the size and activities of the public institution increases or decreases, a complementing budget has to be formulated to meet the changing needs of the public institution. For example, through performance assessments, it may be necessary to identify interventions that address slow delivery of services by a particular public institution and the result might be that additional employees be appointed to monitor activities of such institution, making it necessary to appoint more employees. The appointment will have structural changes to the existing organisational structure. Any structural changes to programme or department's functional structures should receive the necessary attention. The MTEF links revised priorities and new programme structures.

### ***7.3.4 Improvement of budget analysis capacity***

The MTEF improves budget analysis capacity. This means that from the MTEF process, government departments and provincial treasuries should have acquired capacity to model policy variables and to translate policy objectives into financial plans. Government departments and treasuries must furthermore, have agreed on the process for monitoring key performance indicators, and must have acquired the capacity to address issues relating to employee unethical behaviour in terms of the public service regulations and labour relations framework.

### ***7.3.5 Better-informed decisions***

The MTEF replaces conventional forms of budgetary decisionmaking processes that in most instances were not open to the public. The MTEF gives direction to budgetary decisionmaking process that is more accountable, legitimate and credible. Political accountability should increase at both the political and managerial levels through greater transparency. The MTEF encourages politicians to take a lead in identifying priorities and that they must be willing to fund them. Managers in public institutions are also held accountable to achieve outcomes specified in the MTEF. The MTEF facilitates cooperative and consensus-based decisionmaking since it allows for scrutiny by members of the society and the private sector.



### ACTIVITY

*List and briefly explain the outputs of the MTEF process.*

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To conclude this section, the key points and benefits are re-emphasised:

#### Key points

- Three-year spending plans will be published in the budget.
- These plans will reflect the government's political priorities.
- The plans will begin to set out what they mean for public services.
- Budgets will better reflect the strategic direction of government policy.
- Reconstruction and development will be the focus of the three-year plan.

#### Benefits

- Money will be allocated to priority services.
- More efficient planning and management will be achieved.
- The framework will promote the assessment of policy proposals.
- Rollovers will be reduced.
- More open government and credibility will be promoted.

## 8 IMPLEMENTATION AND EVALUATION OF THE MTEF AND BUDGET

Planning and implementation are often forced apart owing to changing circumstances, to the extent that outcomes do not reflect the original planning objectives. The MTEF should supplement the annual budget and vice versa so that the budget depends on the forecasting element of the MTEF to be better prepared in terms of identifying priorities within the associated financial constraints and macroeconomic framework.



Since the MTEF is updated annually with the forward budget estimates, revisions obviously occur. This enables comparisons to be made between estimates and revised estimates. The budget review, relates to various categories in terms of which revised estimates to the MTEF have been made. They are as follows:

- National budget expenditure
- Changes in national budget expenditure estimates: budget to budget
- Preliminary expenditure outcome and revised estimate
- National budget medium-term expenditure estimates
- National budget expenditure
- National budget expenditure: changes from the budget and growth in spending
- Consolidated national and provincial spending
- Consolidated national and provincial spending by function
- Economic classification of consolidated expenditure

The above serves to indicate the variety in the application of the MTEF and how it is combined with annual budgetary information to adapt and revise estimates as required. In essence the budget and the MTEF are mutually integrated, where one serves a micro-oriented purpose and the other takes a macro approach to national expenditures. Since annual expenditures can now be associated with estimated expenditures over the medium term and the base year of the MTEF comprising forward estimates, comparisons between planned estimates and expenditures can be drawn over various periods, which will facilitate better expenditure controls.

## **9 BASIC PRINCIPLES OF THE MTEF PROCESS**

Budgeting within the MTEF is based on a set of basic principles. These basic principles include (1) fiscal policy and the budget framework, (2) policy priorities and public expenditure, (3) political oversight and the budget process, as well as (4) budgeting for service delivery. A brief explanation of these basic principles follows in subsequent sections of the study unit.

### **9.1 Fiscal policy and the budget framework**

Fiscal policy refers to national government's decisions regarding the nature, level and composition of government expenditure, taxation and borrowing and is aimed at pursuing a particular goal. The policy is the budgetary stance of government and, amongst other, it is concerned with how much revenue is raised, how it is raised and on what is that budget spent. As described in the 2002 Treasury guidelines, medium-term spending plans of national and provincial departments are prepared within the context of the government's macroeconomic and fiscal

framework. The macroeconomic projections and fiscal framework are revised during each year, as updated data becomes available. The incorporation of the data on macroeconomic projections and fiscal framework helps to improve transparency and accountability, while at the same time giving a clear picture of tax and spending. The framework also includes a contingency reserve to provide for unanticipated expenditure and macroeconomic uncertainty as well as new spending priorities. In the nature of the 3-year rolling budget process, the budget process is revised each year.

## **9.2 Policy priorities and public expenditure**

As noted in the previous discussion, the medium-term budgeting process strengthens the link between government's policy priorities and public expenditure. Public expenditure translates policy priorities into the delivery of services, and is therefore important for achieving public goals. The implementation of medium-term planning reinforces the link between policy choices that government makes, its budget and the delivery of services. Evidence of the practical use of this principle in the South African context is highlighted by the identification of poverty as a major priority to which the government has invested a large proportion of the budget in alleviating it. In recent years much of the budgets have been directed at alleviating poverty and achieving the goals of a transformed society.

## **9.3 Political oversight and the budget process**

Despite strengthening the link between policy priorities and public expenditure, the medium-term financial planning enhances political oversight. Engagement at political level, with Cabinet involvement in the early stages of the budget formulation gives substance to the MTEF process. If the politicians are not willing to take part in the budgeting process and fail to commit to policy priorities, the whole budget process will be undermined, and this will lead to poor budget implementation. The Cabinet, supported by the Ministers' Committee on the Budget, the Budget Council and the Budget Forum, plays a leading role in guiding the alignment of resources allocation with national priorities. At the provincial level, the MECs for Finance and the Executive Councils play a parallel role in guiding the alignment of resource allocation with provincial priorities. The Budget Forum also plays a significant role in advising Cabinet on the resource allocation for the local sphere of government. Political oversight of the budget process is important for two major reasons, first to ensure that the political office bearers are responsible for policy and budget planning and prioritisation, and secondly to ensure that policy priorities are linked to departmental spending plans and the delivery of services.

## 9.4 Budgeting for service delivery

The principle of budgeting for service delivery identifies government's goals as intended at improving service delivery and ultimately the quality of life of communities. Budgeting for service delivery is enhanced by the Public Finance Management Act (PFMA), which sets out a framework for modernising the financial management systems of national and provincial departments, government agencies and other public institutions. The Act gives public managers greater flexibility while at the same time holding them accountable for the use of resources to deliver services to communities.



### ACTIVITY

*List the basic principles of the MTEF.*

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## 10 KEY DECISION STAGES IN THE MTEF PROCESS

In terms of the National Treasury guidelines 2002, 2006, 2007 and 2009, the MTEF process consists of a series of decision stages. These key decision stages are the building blocks in the preparation of the budget. The process consists of seven overlapping or interlinked stages that correspond to the critical decision nodal points. The stages in the MTEF process are briefly described below.

**Stage 1: Prioritisation stage**

The first stage of the MTEF process commences in April and entails the identification of spending priorities. During this stage, the Ministers' Committee on the Budget, the Budget Council, the South African Local Government Association (SALGA) and Cabinet considers policy priorities for the medium-term expenditure period. It is also in this stage where policy choices and trade-offs are made. The prioritisation stage focuses on spending priorities and guides resource allocation decisions for the medium-term strategic priorities.

**Stage 2: Preparation and review of the MTEF budget**

The preparation and review of the MTEF budget is the second stage in the budget process and entails annual revision of the MTEF budget after the departmental performance assessments have been completed and corrective measures been identified. The need to table the strategic plans in parliament depends on the significance of changes to priorities or significant revisions to performance targets.

**Stage 3: Review of the macroeconomic and fiscal framework and the division of revenue**

The discussion of the basic principles of the MTEF highlighted the need to focus on macroeconomic and fiscal frameworks as important budget principles. Medium-term spending plans are prepared within the context of the government's macroeconomic and fiscal framework. During this stage, the macroeconomic projections and fiscal framework are revised and updated. This stage gives a clear picture of the revenue and the budget that will be available for spending.

**Stage 4: Medium-term allocation process: recommendation stage**

This stage of the budget highlights activities in the medium-term allocation process where budget recommendations are made. It is initiated during the Medium Term Expenditure Committee hearings and discussions at the national and provincial spheres of government between September and October of every year.

**Stage 5: Medium-term budget policy statement**

The fifth stage of the budget process focuses on the medium-term budget policy statement. During this stage government's broad medium-term policy and spending plans are considered by Cabinet and are tabled before Parliament. The medium-term budget policy statement is initiated during October of every year.

### Stage 6: Medium-term allocation process: decision stage

As opposed to the fourth stage, the sixth stage of the MTEF process focuses on decisions, not recommendations. This stage is initiated during November and facilitates the determination of the new medium-term allocations to national votes and those to provincial and local spheres of government.

### Stage 7: Preparation of the budget

The preparation of the budget is the last stage in the MTEF process and is inclusive of activities in which national and provincial departments work closely with the National Treasury to prepare the budget documentation that is tabled before parliament and before provincial legislatures.



#### ACTIVITY

*List the seven interrelated key decision stages of the MTEF process.*

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The Chancellor proceeds to indicate that the above measures will tighten spending control and lead to a more strategic approach to public expenditure planning and better prioritisation of resources by departments. In the past, they have suffered from being able to plan only one year ahead and have been forced to use up vital resources at the end of the year when these could have been better spent the following year ([www.HM-Treasury.gov.uk](http://www.HM-Treasury.gov.uk)).

Budgeting and its associated processes are in a constant flux of change to improve financial decisionmaking. Too often in the past such attempts merely represented structural changes in the budget format, which resulted in ad hoc attempts and uncoordinated reform approaches. Streamlining the budget and its processes and including all related elements serves to promote a comprehensive approach, which will eventually enable financial planning to achieve the right objectives in the right way, despite the constraints of decreasing resources.

## **11 RECONCILIATION OF THE MTEF AND DEPARTMENTAL SPENDING PLANS**

According to the *Manual on the financial planning and budgeting system of the state*, the compilation of the overall budget for the forthcoming year and estimates for subsequent years requires a reconciliation between the Medium Term Expenditure Framework and spending plans of government agencies. The reconciliation process involves the evaluation of budget planning submissions by the National Treasury and consideration by the Budget Committee of representatives from all departments, together with a further review of the Medium Term Expenditure Framework. Against the background of fiscal constraints and government's social, economic and developmental policy commitments, adjustments to departmental spending plans and programmes as well as the MTEF may be required.

## **12 CONCLUSION**

Planning objectives and allocating resources to these objectives have in the past been one of the most difficult functions of government departments. Despite the advent of modern systems of budgeting and of financial management in the public sector, this problem will remain an integral consideration within the public domain. It can also be stated with a reasonable degree of certainty that no system of budgeting or of financial management will in the foreseeable future be able to neutralise the problem. Simply put, there will always be fewer resources than are needed – indeed, needs seem to be accelerating at an alarming rate in relation to the rate at which resources can be increased. Therefore proper and efficient financial planning is of paramount importance.

The importance of financial planning with regard to the budget is certainly also not new. In the past it has been the driving force behind numerous efforts in the field of public sector financial management – for example, to establish new ways of budgeting (budget reform), to manage better (financial management reform movements), to achieve better accounting of assets and liabilities, and to incorporate management aspects such as risk management and fund management.

The remaining possibility is to make the best of what you have, utilising the available resources optimally. This requires that a mechanism be available by which financial decisionmaking can facilitate decisions on spending to achieve an optimal utilisation of resources. The use of budget procedures such as the Medium Term Expenditure Framework system represents an effort to overcome the adversity of a decreasing resource base. The assumption is that better planning will result in better spending achievements and that the maximum possible benefits will be derived from each rand spent.



### 13 SELF-ASSESSMENT

1. Describe and explain the relevance of the difference between short and medium-term financial planning. (12)
2. Identify and explain the usual elements of financial planning using a structured method. (10)
3. What are the basic elements of a medium-term financial plan? (10)
4. Describe and explain the benefits of a medium-term budget. (5)

## 14 FEEDBACK ON SELF-ASSESSMENT

1.
  - **Short term:** This is normally one year in formal institutions. For financial and accounting purposes this is known as a 'financial year' or a 'book year'. In the private sector no year-end date is prescribed, which means a company can decide when it wants its financial year to start and when the year end should be. The rule is 12 months, which means that the start of the financial year automatically denotes what the year-end date will be. It is important to consider the start of the financial year for the purpose of financial planning, because planned objectives for the short term should not exceed 12 months. In the public sector the date of the new financial or book year is determined by legislation. The time-frame is 12 months, starting on 1 April and ending on 31 March of the ensuing year.
  - **Medium term:** The medium term can be anything between three and five years. The purpose of financial planning over these periods is necessary to determine the financial needs (and possibly constraints) for a particular period into the future, importantly with a fixed starting date. This is particularly with regard to developmental or capital projects, or projects where the ultimate objective cannot be achieved without first achieving other intermediate objectives. Examples of such ventures are numerous, such as road construction, stormwater drainage systems, land purchases (by government), community development programmes, extension of communication networks or creation of employment schemes.
2.
  - Identifying objectives – this can be done by the board of a private firm or by the Cabinet in the case of the public sector.
  - Aligning the objectives in terms of a strategic plan (not business plan, because the financial plan is part of the business plan).
  - Dividing objectives in terms of identifying their constituent parts.
  - Associating costs with each of the various subdivisions of the main objectives, to the lowest possible level, to prevent hidden costs from emerging only after the process of implementation has started.
  - Working out alternative options to achieve objectives if the process of costing (or estimation) proves too expensive – any institution will generally have a good idea of the financial resources at its disposal (whether investment funds, savings, loans or taxation income in the case of the state) and this information serves as basic point of departure where estimation and costing is done as part of financial planning.



- Presenting the objectives and sub-objectives schematically, including the financial implications, source of funds, time-frames if required (for contracting purposes) and responsible persons (accounting officers, programme managers, regional managers) in each case.
  - Using the schematic presentation to align with the business plan of the institution or operational plan, in order to obtain approval to spend the funds on the objectives as planned; in the case of the state, Parliament needs to authorise spending, whereas in the case of the private sector it could be the managing director, board members or any form of authorisation pertaining to a particular institution.
- 3.
- Macroeconomic analysis linking the growth of national income, savings, investment and balance of payments to public expenditures and revenue (while this is not possible with a short-term financial plan).
  - A rolling, multi-year public investment programme with phased outlays reviewed annually.
  - A fiscal plan, which includes:
    - revenue forecasts at existing rates of taxation consistent with the macroeconomic assumptions
    - forecast of non-tax revenues (surplus of public enterprises, fees, user charges) based on macroeconomic projections but without any change in policy
    - estimation of additional revenues that may be mobilised by, for example, higher tax rates, a different tax structure or institutional and administrative reforms in tax collection
    - estimation of additional income resulting from changes in the policy framework for public enterprises, public sector pricing policy, changes in the social sector and so forth
    - estimates of resources available from domestic and external borrowing and grants
    - projections of current expenditure including debt servicing, defence, administration and recurrent expenditure on development (subdivided between committed and anticipated discretionary expenditures)
- 4.
- Enabling spending agencies to consider how best to deliver public services and transformation within realistic projections of their budgets.
  - Establishing a framework for assessing new policy proposals.
  - Fostering medium-term planning by spending agencies.
  - Allowing agencies to enter into forward commitments without requiring rollovers of unspent prior allocations.
  - Improving the credibility of fiscal policy.

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# BUDGET INTEGRATION AND ANALYSIS IN THE PUBLIC SECTOR

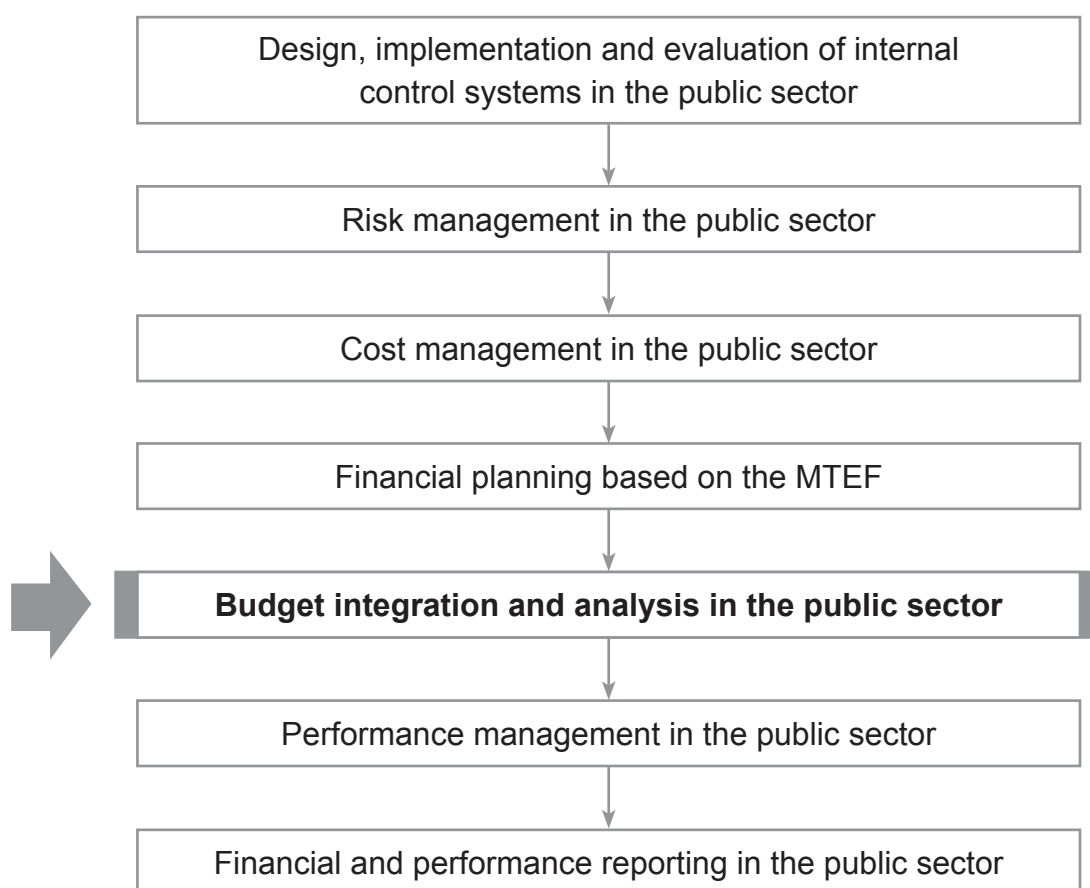
UNIT

**5**

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**ROUTE MAP**

Use the route map below to determine where you are within the syllabus and where this study unit fits into the module:



## LEARNING OBJECTIVES

After studying this unit, you should be able to:

- distinguish between the extrinsic and intrinsic properties of budgets
- associate the extrinsic properties of budgeting with public financial management
- link the intrinsic properties of budgeting to the budgeting process
- link analysis of the budget to its intrinsic properties

## 1 INTRODUCTION

A budget elicits various responses from public officials and politicians. From a political perspective, a budget is basically an instrument through which political decisionmaking is legalised and executed, whilst in the view of public officials, the budget is a mechanism through which planning, financial authorisation and control are exercised. The budget cycle, representing a financial year, comprises various sequential phases, each of which must be completed before the ensuing phase proceeds. It should be noted that budgets constitute both intrinsic and extrinsic elements – which is what this chapter is about.

The intrinsic properties of a budget reflect a micro-perspective involving the specific technical details of spending objectives per department. In contrast, the extrinsic properties relate to the budget as an instrument of macroeconomic and fiscal policy dimensions, where individual departmental spending objectives are not of concern but rather their compounded effect.

This specific unit relates to budget integration and analysis, which implies that the extrinsic properties of the budget should be addressed rather than its intrinsic properties. However, the extrinsic dimensions cannot be dealt with before the detailed information serving as a framework has been determined.

For the purpose of this unit a dual approach will be required. In the first instance, the more practical steps in terms of the consolidation of estimates will be dealt with. In the second instance, and relating to the extrinsic propensities of budgets, budget analysis will be dealt with.

## 2 BUDGET INTEGRATION

Budget integration takes place after the original planning and estimation phases, and prior to parliamentary approval. Before budget integration can take place, various elements need to be finalised – this refers to the process of planning, estimating and costing. Remember that in terms of the intrinsic and extrinsic properties of a budget, the detailed objectives need to be clarified (planned and estimated) before the bigger picture can emerge, relating to the extrinsic properties or characteristics of the budget.

However, the National Treasury does have an indication of what it would like the bigger picture to be in terms of the national economy and therefore also the government's fiscal policies. It is for this reason that the National Treasury issues budget circulars to all departments (spending agencies) informing them of the individual spending limitations per department, and thus imposing a framework of financial constraints on all spending agencies. The framework of financial constraints is determined by the National Treasury in terms of affordability, with various aspects being considered, including political directives, economic development plans such as GEAR and the possibility of obtaining loans to defray deficits on the exchequer, if need be.

Budget integration, in the simplest possible terms, literally means putting the various documents of all spending agencies together in one cohesive unit, for two particular objectives. The first objective is to integrate the budget for parliamentary authorisation purposes. Parliament will not consider a fragmented document presented by the Minister of Finance. With regard to the second objective, the National Treasury (provincial treasury in the case of provinces) needs to determine the final compounded financial implications of all spending agencies and therefore the total demand on the exchequer. The picture presented by the integrated budget as a whole differs from the picture presented by its various constituent parts. For instance, it is extremely difficult to determine the effect on the government's economic development plans of economic development spending programmes or social investment spending by a single spending agency or, for that matter, any other programme such as poverty relief programmes. Furthermore, the National Treasury also has to consider matters such as interest on debt repayments as an additional burden on the exchequer, which does not appear in the expenditures of line departments but which must be considered.

Budget integration also provides the National Treasury with the opportunity to align departmental spending objectives with national spending priority objectives and the government's macroeconomic policy framework. Once more, the intrinsic nature of the detailed information provides the basis for the extrinsic value of the budget. Accounting officers of line departments are concerned with the compilation of their budgets in terms of the policy objectives of their departments



and as such are not overly concerned with the government's macroeconomic policy. However, the combined financial obligations of the state over the short, medium and longer term need to be addressed, and by integrating the budget, the combined effect of total intended spending becomes evident. Also, the diminishing resource base of government is an ever-present danger, a matter which is of specific concern to the National Treasury and also the Minister of Finance.

Elements to which the integrated budget relates in terms of the government's macroeconomic policies, which have to be considered by the National Treasury and not necessarily by spending agencies, are the following:

- Economic expansion in South Africa tends to lead to a rapid growth of imports, putting the balance of payments under pressure and constraining the prospects for sustained growth.
- Investment and saving levels, which have been uncharacteristically low in recent years, will need to be substantially increased if strong growth is to be sustained.
- Unemployment remains a major economic weakness, contributing to both the high degree of income inequality and social fragmentation that characterise South Africa.

The above three challenges are the responsibility of the National Treasury. Budgets need to be integrated in order to determine whether the diverse political and economic objectives are being addressed in a manner that is relevant and within the economic parameters concerned.



### ACTIVITY

*Explain why the integration of the budget concerns more than the mere compilation of budgetary requests of spending agencies for the ensuing financial year.*

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### 3 BUDGET INTEGRATION AND FISCAL POLICIES

Fiscal policies relate to the use of fiscal instruments such as spending, taxation and loans to manipulate the economy of a country in a predetermined planned direction. The intention is to make use of fiscal instruments to conform with government's distribution and allocation objectives, which are based on socioeconomic factors, and simultaneously to address particular issues such as poverty relief and social aid, while still conforming with economic development programmes.

In the previous section the short, medium and longer-term objectives of government were mentioned. In relation to fiscal policy objectives, it needs to be reiterated that the effect of fiscal policy objectives is not necessarily linked to a single financial year only but invariably also to the medium and longer terms. The medium-term expenditure plan is a classical example of where annual budgets in their integrated form serve as constituents on a rolling basis. The medium-term expenditure plan cannot be compiled if budget integration and all of its objectives are not achieved.



#### ACTIVITY

*Briefly explain the link between fiscal policies and budget integration.*

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### 4 PRACTICAL ASPECTS OF BUDGET INTEGRATION

What needs to be done before budget integration can take place? If the budget cycle for the planning process is reviewed, the integration process is not a single one-off process but rather a continuous one, as will be seen below.

Spending agencies to submit planning submissions, approved by their Ministers, to the National Treasury	Middle of May
The National Treasury to evaluate inputs from spending agencies	Middle of May until end of June
The National Treasury to present MTEF to Cabinet	First Cabinet meeting of July
Sub-budget Committee to scrutinise recommendations of programme officers	First week of July
Budget Committee to evaluate recommendations and bring recommendations in line with approved MTEF or adjust MTEF	First two weeks in August
Investigations/calculations resulting from Budget Committee resolutions	Middle of August until end of September
Presentation of recommendations by Budget Committee to Minister of Finance, Special Ministers' Committee and Budget Council	First week in September
Presentation to Cabinet	Middle of October
Final allocations (year 0 + 1) as well as provisional expenditure guidelines for years 0 + 2 and 0 + 3 to spending agencies	November
Spending agencies to submit printers' proofs for year 0 + 1 to the National Treasury	Middle of January
Provisional allocations for years 0 + 2 and 0 + 3 announced in Budget Review	Middle of March

## 5 THE PURPOSE OF INFORMATION ON ESTIMATES

Financial reports such as trial balances and balance sheets reflect the historical results of an institution's finances. In comparison, the financial estimate of an institution such as a state department is a summary of the monetary value of all the planned activities of the various subdivisions.

Costs are determined under the various standard items in respect of each activity executed. In this manner the total cost per activity is estimated for a certain financial year. Each programme on a department's budget comprises a number of separate activities. The total cost of a programme is therefore not represented

by a single expenditure item but by the total of the expenditure in respect of the separate activities under the programme concerned.

A financial estimate is compiled for the following financial year. The estimate is principally directed towards determining financial costs in respect of attaining the set objectives for the financial year concerned. At the same time it gives a good indication of the source of funding; furthermore, if the estimate is broken down realistically in terms of expected expenditure for the consecutive months, it should give a good indication of cash-flow requirements. This is therefore a short-term estimate.

In practice, nothing remains static or unchanged during any period of time for any state department – in particular if one considers the tumultuous times our country is experiencing at present. It is therefore not possible to do once-off fixed planning for the undefined future. Each year the costs associated with a specific activity will change; expenditure may increase due to increased prices but could just as soon decrease.

The purpose of an estimate is therefore to indicate the total cost of a planned activity by incorporating the most recent available information.

## **6 FINANCIAL PLANNING**

The basic economic problem is that resources are limited and that not all needs can be satisfied. This leads to allocation problems and the dilemma that not all the needs of all departments can be satisfied.

A multi-term approach to the financing of planned state expenditure is therefore required, and consequently a multi-term plan of expected revenue and expenditure is compiled. Such a plan has to indicate to the state the difference between its expenditure and revenue, the amount to be financed by loans and how this financing should be obtained.

In practice the state's available funds for the next financial year are (in terms of Financial Regulation 2(1)) determined by the three main receivers of revenue:

- The Commissioner of Customs and Excise
- The Commissioner of Inland Revenue
- The Accountant-General

The combined figure represents the expenditure ceiling. The revenue deficit is determined according to strictly coordinated control over the state sector's forecasted expenditure and the determination of priorities within this planned total expenditure. The state must then determine what additional funds can be required by way of tax adjustments or additional loans.

The state cannot, however, act as it pleases on this subject and must consider several factors. The state has to take into consideration the extent of the availability of funds in the capital market for the financing of additional deficits. Excessive attachment of the country's resources by the state sector per force leaves less room for expansion by the private sector, which is usually the creator of wealth. The state will therefore have to carefully consider the disadvantages of financing additional resources against the disadvantages of limiting state expenditure, and determine the upper limit of expenditure accordingly. Such a final upper limit always restricts the satisfaction of needs as reflected in planned expenditure, and results in individual allocations having to comply with it.

## **7 MULTI-TERM EXPENDITURE PLAN**

It is important to the state not only to have a short-term financing plan but also to plan for the longer term.

- Short-term planning can be seen as an active planning process, with the accent on the detail of activities in the pursuit of an objective.
- Long-term planning is a strategic planning process in which objectives are viewed in broader perspective.

Cabinet has already accepted the recommendation that the state should operate according to a three-year expenditure programme to establish the principle of multi-term expenditure planning in the state sector. The long-term expenditure guidelines of the respective state services are determined in accordance with the specific policy objectives as established. These guidelines provide the framework within which the funding requests of the state's budget are considered and allocated.

## **8 PRINCIPLES OF PRIORITY DETERMINATION FOR THE BUDGETING PROCESS**

The process of priority determination to which the annual budget process is linked endeavours to establish a few important principles:

- Collective ministerial responsibility for the nature and extent of state responsibilities and for control over and allocation of state resources
- Consideration of competing claims against the backdrop of the full implication of state expenditure over both the short and long terms
- Long-term expenditure planning

- The application of zero-based budgeting
- Continuous analysis, evaluation and improvement of programme and expenditure effectiveness

In practice the process encompasses the following elements:

- The nature of the state's responsibilities is formulated in terms of various overall functions such as defence, education, health and others; long-term policy objectives in respect of each functional area are also formulated.
- These objectives, depending the nature of the functions, may be relevant to different periods – for example, achieving a certain teacher/pupil ratio by the year 2010 in education, or achieving a certain numerical strength for the police force by the year 2005.
- The formulation of such objectives is coupled with a calculation of the financial implications at current prices over the period as a whole, as well as a determination of other implications required for decisionmaking purposes.
- Each function is examined against the backdrop of meaningful choices in respect of policy objectives that can be financed over the long term, with a view to the formulation of policy options with various financial implications.
- A moving five-year expenditure plan on a functional and vote basis is formulated (once per annum). This plan is based on the analysis and is accompanied by the applicable set of policy objectives for the various functional areas on which expenditure amounts are based.
- The course is monitored, and the effectiveness of expenditure in terms of laid-down objectives is evaluated.
- Policy objectives are revised and adjusted according to a set procedure as a basis for fundamental variations to the five-year expenditure programme. New function investigations or the revision of previous function investigations will be undertaken in this regard.

## **9 MEDIUM AND LONG-TERM ESTIMATES**

To enable the former Department of State Expenditure to inform Cabinet regarding the expected course of state expenditure and to establish guidelines for departments, the Department requested accounting officers in terms of Financial Regulation 1(1)(d) to submit annual long-term expenditure estimates in respect of each programme to the Department of State Expenditure. (With effect from 1 April 2000 the functions of the Department of State Expenditure and the Department of Finance were transferred to the National Treasury.)

Medium-term estimates are captured in the medium-term expenditure framework, which correlates with the medium-term revenue framework of government. This enables government to make forecasts about its future financial requirements. The publication of such estimates also provides the private sector and investors with a picture of future government financial requirements and its potential impact on both the foreign and domestic capital markets.

For instance, if projected revenue requirements of government over the longer term escalate in favour of economic development programmes, the future prospects for investment purposes can be positively interpreted. In contrast, if future spending is aimed more at poverty relief programmes through transfer payments, companies will probably be more conservative in terms of expanding and be content to contribute to reserves to provide for future tax increases beyond the average scales.

To conclude, budget integration involves more than the mere compilation of various budgets from spending agencies. In a sense, the budget is also integrated with other objectives, as stated above.



## ACTIVITY

*Explain how medium-term planning and long-term planning are associated with each other.*

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## **10 BUDGET ALLOCATIONS**

Technically, budgeted amounts become available once legislative approval is obtained. Since the financial year starts at 1 April and ends at 31 March of the ensuing year, it is assumed that legislative approval is obtained before the next financial year starts. In practice, legislative approval by Parliament does not correspond with the start of a financial year. In this regard the budget approval processes follow a different route from the prescriptions about a financial year for financial year-end closing procedures.

In practice it can happen, therefore, that the budget for a particular year is approved as late as July or August. Since legislative approval is obtained after the start of the new financial year, departments or spending agencies are theoretically involved with unauthorised spending from 1 April of the new financial year. The alternative option is that spending agencies cease all payments until such time as approval is obtained. This, however, would lead to chaos, since salaries would be unpaid, pensions withheld, food deliveries to hospitals halted, and so forth. Since these consequences cannot be accepted, payments continue as always from 1 April, with one specific exception.

Payments are allowed to be continued for all previously agreed and approved new programmes (such as for personnel, pensions and so forth) that are included in the budget but still need to be approved by Parliament. Until approval for such new programmes is obtained, expenditures on them will need to be withheld.

### **10.1 Monthly allocations**

Allocations to spending agencies are done monthly. The reason why spending agencies do not receive their annual allocations in one bulk payment after legislative approval is simply that the money is not yet available. The second reason is financial control. It is extremely difficult to track financial transactions and the resulting flow of money between transactions and between revenue and expenditure. The money is not available at the start of the financial year because revenue is being raised via taxation at more or less the same rate at which spending agencies expend their budgets.

Technically, spending agencies receive their approved budgets in 12 installments. Owing to possible changes in circumstances affecting the spending patterns of spending agencies, in some months they may need less than the budget provides and in some instances more. To prevent spending agencies from having deficits at crucial times or, alternatively, from having surplus underutilised funds, the flow of money between the exchequer and spending agencies needs to be carefully monitored by the National Treasury.





## ACTIVITY

*Why is it not possible for spending agencies to receive their approved budget in a one-off transfer?*

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## 10.2 Revenue requests

Requests for funding are prepared on a monthly basis by spending agencies and submitted to the treasury. Such requests must be submitted in advance of the months in which the revenue is required by the spending agency. Simultaneously, requests need to be prepared for on a quarterly forecasted basis. The reason for these quarterly (three-monthly) forecasts is to notify treasury of impending needs for a longer period than a month and also to create an awareness of any extraordinary needs.

When compiling the revenue requests, programme managers will need to state the following information:

- the remaining balance of the specific programme
- changing circumstances affecting financing needs
- the possibility of over- or underspending
- forecasted needs for three months

By processing the monthly requests as well as the quarterly forecasts, accounting officers can keep track of the flow of funds in their departments. This enables them to manage funds more effectively, since possible areas of overspending become evident in advance, unless the programme managers themselves do not represent the true factual information to the accounting officer. Quarterly forecasts are also adapted on a monthly rolling basis, with the result that the figures of the latest addition to the quarterly request can be compared with the monthly request for that month to check for variances. This indicates the degree of accuracy with which accounting officers and programme managers manage the funds in their respective departments and programmes or subprogrammes.



### ACTIVITY

*What type of information must programme managers generally provide when they compile their monthly requests for funding?*

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## 10.3 Financial reporting

To conclude this section, the relation between financial reporting and budget allocations needs to be clarified. Reports on the state of expenditure should not represent efforts by spending agencies to extract more funding from the exchequer. Financial reporting exists to allow treasury the opportunity to monitor the flow of money on a national basis.

## 11 BUDGET ANALYSIS

The concept of budget analysis is exceptionally wide. The question to be asked in this regard is what exactly needs to be analysed. Various possibilities comes to mind, such as the following:

- the ability of the budget to deliver policy objectives effectively
- the effectiveness of the budget in terms of the allocation and distribution principles of the state
- the budget as an instrument in identifying the most relevant priorities of the state
- the use of the budget and its inclusive processes to make the most of scarce resources
- the use of the budget to manage expenditures efficiently, effectively and economically
- the use of the budget to implement economic development programmes effectively

- the use of a particular budget type as opposed to another type of budget
- the use of the budget as a mechanism through which the government's fiscal policy is exercised
- the use of the budget for financial control purposes
- the use of the budget as a mechanism for audit and accountability

From the above list it is evident that budget analysis can suit a variety of purposes and objectives, depending on the particular approach or client. For example, as the list indicates, budget analysis may be used for a number of evaluation and analysis procedures in which the information analysed can vary from detailed technical aspects, intrinsic to the budget, to aspects relating to the wider political economy, extrinsic to the budget.

By way of a process of elimination, some of the elements in the above list can be discounted in respect of public financial management. For instance, budget analysis in terms of an applied economics approach would not concern the accounting officer of a spending agency. Sociologists would be concerned with the impact of the budget on poverty relief, for instance, and its effects on social patterns such as those associated with crime. The private sector would analyse the budget in terms of its impact on taxation, investments, and so forth.

A budget, as analysed, could be interpreted as having an economic developmental nature, for example, or perhaps be interpreted as being too socialistic or overly directed towards social investment. However, from a public financial management perspective, the budget serves another purpose in terms of budget analysis that is of concern to the student in this subject field.

### **11.1 Intrinsic budget analysis**

Accounting officers are not really concerned with the extrinsic properties of budgets in terms of analysis. They are not concerned with whether the budget sufficiently addresses the state's distribution or allocation function, or whether it serves as a conduit of the government's fiscal policies. Nor are they concerned about the impact of the budget on the activities of the private sector.

In terms of the Public Financial Management Act 1 of 1999 and the Treasury Regulations issued in terms of the Act, accounting officers should be concerned with the expenditures according to their respective budgets during a financial year. Generally, in terms of the above requirements and prescriptions, accounting officers must be concerned with the following:

- taking due care not to exceed their budgets
- taking due care to deliver programmes according to the budget
- taking due care to manage their budgeted funds effectively, efficiently and economically

- taking due care to ensure that funds are used according to the budget without deviation
- taking due care that objectives according to the budget are achieved

The above elements provide the basis and the parameters for budget analysis for accounting officers and therefore for the state. These elements relate to the intrinsic properties of the budget, since they can be quantified mathematically, compared and therefore analysed.

## **11.2 Mathematical quantification**

In terms of the elements listed in the previous subsection, one particular characteristic is that they are almost all mathematically quantifiable. The one exception is where performance is measured without the use of financial statements – performance is analysed in terms of predetermined indicators, reflecting a value judgement more than anything else.

By mathematical quantification we mean that analysis is based on the use of exact numerical figures representing the existence of financial transactions. In terms of this, revenue can be matched (analysed) with expenditures, expended funds can be correlated with remaining funds and future commitments, and so forth. In other words, each cent can be accounted for, whether revenue or expenditure. If this is the case, it can be assumed that budget analysis represents a management tool by which the state's finances are managed and not necessarily a mechanism to find fault with the accounting officers or other public officials.

To be of any real value, budget analysis needs to be programmed, structured and formalised through legislation. This means that particular forms must be used and specific reporting channels must exist, and these will need to form part of the financial management system of the state. What is of particular importance is that these forms and channels and this system should be the basis of the accounting system in government. The reason is that accounting records that reflect financial statements and therefore indicate the flow of funds can be used for analysis, control, auditing and eventually accountability.

The advantage of such a system is that, for instance, escalation rates in itemised functions can be evaluated for concurrent years per activity type, expenditure type and standard items such as personnel, administration, stores and livestock, equipment, and land and buildings. In this way discrepancies can be identified and causes determined, but the overall purpose would necessarily be that of financial control and eventually public accountability.

## **12 CONCLUSION**

Consolidation of estimates and budget analysis are brought together by the intrinsic and extrinsic properties of the budget. The way in which the budget is integrated and the extrinsic elements to which it relates are eventually consolidated through the process of budget analysis.

Budget analysis, to be of any use, needs to be structured formally according to precise standards and formats. Otherwise budget analysis will be regarded as having little practical relevance. The value of proper budget analysis, on the other hand, is considerable, since it provides the basis for proper financial management in the public sector.



### 13 SELF-ASSESSMENT

1. Distinguish between the intrinsic and extrinsic properties of budgets. (5)
2. Identify three specific elements relating to the extrinsic properties of budgets that the National Treasury considers when estimates are consolidated. (3)
3. What is the basic purpose of a financial estimate? (8)
4. What is the basic difference between short-term plans and long-term plans? (2)
5. What are the various possibilities that exist in terms of which budgets can be analysed? (10)

## 14 FEEDBACK ON SELF-ASSESSMENT

1. The intrinsic properties of a budget can be related to a micro-perspective, since they reflect the specific technical detail of spending objectives per department. In contrast, the extrinsic properties relate to the budget as an instrument of macroeconomic and fiscal policy, where it is not the individual departmental spending objectives that are of concern but rather their compounded effect. This study unit deals with budget integration and analysis, which implies that the extrinsic properties of the budget should be addressed rather than its intrinsic properties.
2.
  - Economic expansion
  - Saving and investment levels
  - Unemployment
3.
  - Financial reports such as trial balances and balance sheets reflect the historical results of an institution's finances.
  - The financial estimate of an institution such as a state department is a summary of the monetary value of all the planned activities of the various subdivisions.
  - Costs are determined under the various standard items in respect of each activity executed.
  - In this manner the total cost per activity is estimated for a certain financial year.
  - Each programme on a department's budget comprises a number of separate activities.
  - The total cost of a programme is therefore not represented by a single expenditure item but by the total of the expenditure in respect of the separate activities under the programme concerned.
  - Short-term planning can be seen as an active planning process with the accent on the detail of activities in pursuit of an objective.
  - Long-term planning is a strategic planning process in which objectives are viewed in broader perspective.
5.
  - The effectiveness of the budget to deliver policy objectives
  - The effectiveness of the budget in terms of the allocation and distribution principles of the state
  - The budget as an instrument in identifying the most relevant priorities of the state
  - The use of the budget and its inclusive processes to make the most of scarce resources
  - The use of the budget to manage expenditures efficiently, effectively and economically

- The use of the budget to implement economic development programmes effectively
- The use of a particular budget type as opposed to another type of budget
- The use of the budget as a mechanism through which the government's fiscal policy is exercised
- The use of the budget for financial control purposes
- The use of the budget as a mechanism for audit and accountability



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- South Africa. Department of State Expenditure. 2000. *Manual on the financial planning and budgeting system of the state*. Pretoria: Government Printer.

## 16 FURTHER READING

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# PERFORMANCE MANAGEMENT IN THE PUBLIC SECTOR

UNIT

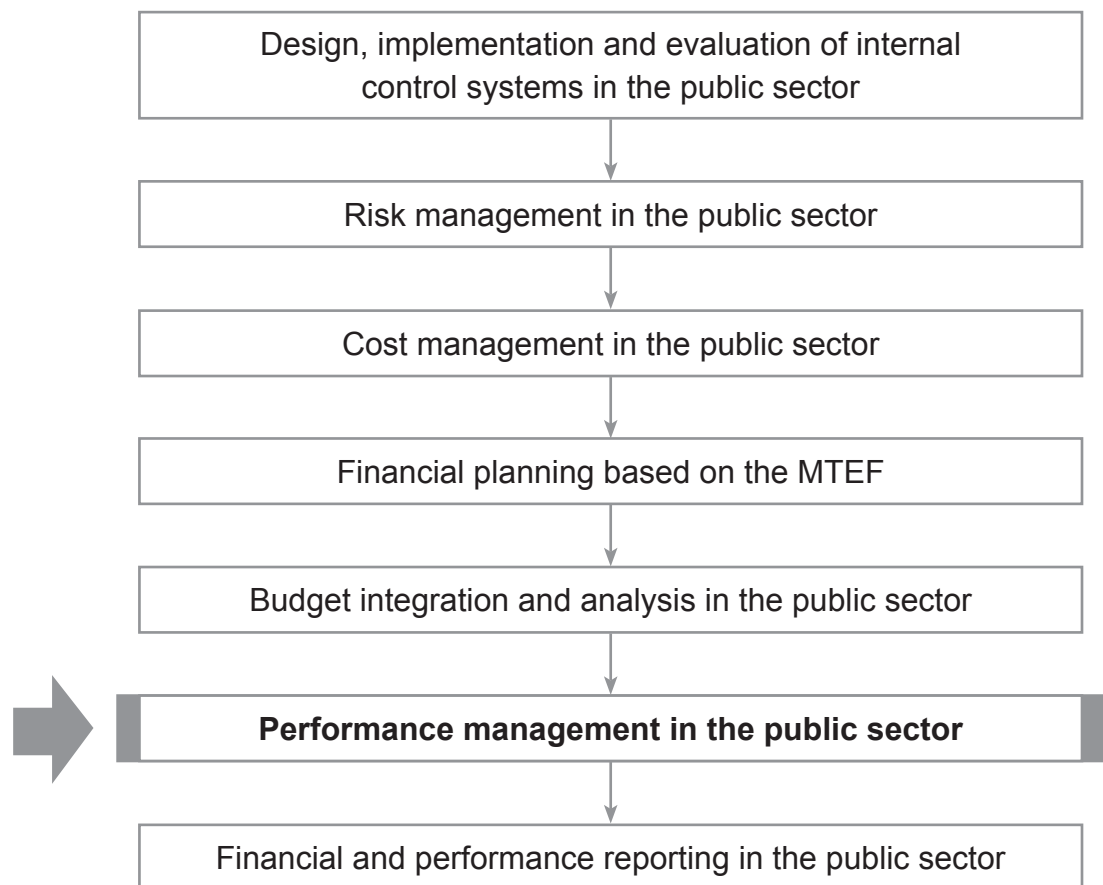
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## ROUTE MAP

Use the route map below to determine where you are within the syllabus and where this study unit fits into the module:



## LEARNING OBJECTIVES

After studying this unit, you should be able to:

- describe the key principles of performance management
- describe the regulatory framework for performance management
- describe the components of performance management
- describe the role of accruals and resource accounting in performance management
- describe and explain how performance can be measured
- describe the importance of performance contracting in the public sector
- describe the purpose and reason for performance auditing
- describe performance reporting as part of the performance management process

## 1 INTRODUCTION

Government performance has, post-1994 democratic elections in South Africa, surfaced as a highly debated issue. The role and speed at which government is expected to deliver is seen in the context of accelerating the transformation process with which government aims to reduce service delivery backlogs experienced in most communities. In terms of the South African experience, most communities, especially black communities, have expressed their dissatisfactions, through often violent service delivery demonstrations, with government's pace of service delivery around most basic services. In turn, the service delivery demonstrations have sourced enormous political intervention.

Performance management is about sound accountability. It provides the public, as well as political office bearers with transparent feedback about service delivery since the performance of the public sector can be measured against the outputs and outcomes achieved. The discussions in this study unit focus on the institutionalisation of performance management in the public sector. The first part outlines the key principles of the performance management, whilst the second describes the regulatory framework within which the performance management is embedded. The subsequent sections highlight various components of

performance management. These components include accruals and resource accounting, resource or performance budgeting, performance measurement, contracting, auditing and reporting.

## **2 KEY PRINCIPLES OF PERFORMANCE MANAGEMENT**

The key principles underlying the need for the implementation of performance management are outlined in various Public Service Regulations. The principles are:

1. Departments shall manage performance in a consultative, supportive and non-discriminatory manner in order to enhance organisational efficiency and effectiveness, accountability for the use of resources and the achievement of results.
2. Performance management process shall link to broad and consistent staff development plans and align with the department's strategic goals.
3. Performance management processes shall be developmental, and shall allow for effective response to consistent inadequate performance and for recognising outstanding performance.
4. Performance management procedures should minimise the administrative burden on supervisors while maintaining transparency and administrative justice.

## **3 REGULATORY FRAMEWORK FOR PERFORMANCE MANAGEMENT**

As Seemela (2008:205) asserts the authorisation for and thrust of performance management in the South African public sector, derives from legislation, Public Service Regulations and resolutions of the Public Service Co-ordinating Bargaining Council (PSCBC). The subsequent discussion focuses on the legislative framework for performance management in the South African public sector. The regulatory framework can be summarised into Acts of Parliament, the White papers, regulations and collective agreements that makes provision for the institutionalisation and implementation of performance management by the South African public sector. The regulatory framework for performance management is outlined below. This framework serves only to introduce and to familiarise the students with various pieces of legislation, regulations and collective agreements and does not provide a discussion of each.

**Acts of Parliament**

- Constitution of the Republic of South Africa 1996
- Public Service Act 1994
- Labour Relations Act 1995
- Skills Development Act 1998
- Basic Conditions of Employment Act 1997
- Employment Equity Act 1998
- Public Finance Management Act 1999

**White papers**

- Human Resource Management 1997
- Transforming Public Service Delivery 1997 (Batho Pele White paper)
- Public Service Training and Education 1998
- Transformation of the Public Service 1995
- Affirmative Action in the Public Service 1998

**Regulations**

- Public Service Regulations 2001
- Treasury Regulations 2000 and 2001

**Collective agreements**

- PSCBC Resolution 13 of 1998 (performance agreements)
- PSCBC Resolution 3 of 1999 (financial rewards and incentives)
- PSCBC Resolution 7 of 2000 (rank/leg promotions and pay progression system)

## **4 ACCRUALS AND RESOURCE ACCOUNTING**

According to Mellett (1998:3) resource accounting involves the use of accruals accounting techniques to report performance in the public sector. This view is confirmed by Archibald (1994:167), who describes resource accounting as a type of accruals accounting under development for government departments.

The accruals concept refers to the situation where income is accounted for when earned and costs are accounted for when incurred (Archibald 1994:161). An accrual is therefore an adjustment that reflects the timing difference between receipts of goods and services and the recording of the invoice. As such, an accrual increases the cost for the current period so as to include such items.

These techniques are seen as a milestone in modernising state finance, as they shift the focus to resources rather than cash consumption. They also reflect



the economic significance of capital and current expenditure and encourage greater emphasis on outputs and on the achievement of aims and objectives. Change or modernisation in public sector accounting has also included work on improved costing and budgeting as well as in management accounting in general (Perrin 1998:7). The main change to attract public notice has, however, been the movement towards full accruals accounting, with the consequent effects on financial reporting and accountability.

Linked to a framework of objectives and related to outputs, the widened use of accruals-based accounting has been designated as 'resource accounting', especially in the context of public institutions (Likierman 1997:246). In the public sector, perhaps more critically than in the private sector, capital asset accounting has often been the area of accruals accounting's greatest interest and controversy.

As indicated earlier, accruals accounting recognises income when it is earned and cost when it is incurred (Archibald 1994:18). It is therefore not interested in receipts and payments, and the actual timing of the receipt or payment of cash is irrelevant. As such, income is earned when the services or goods are provided to the customer and may include items where the cash was received at an earlier stage or will be collected at a later stage. Costs are incurred when goods or services are received or used although not yet paid for.

In effect, accruals accounting allows the income earned from services or goods to be properly matched with the costs incurred in delivering the services or providing the goods. In fact, the financial statement showing what has happened in accruals terms over the period is the operating account. At the same time, the value of everything the public institution owns and owes at the end of the period, usually the financial year, is shown in a balance sheet. These are the two key financial statements that result from the use of accruals accounting.

Used in this way, the process of accounting is no longer simply a neutral exercise of recording and reporting facts but is a means to achieve stated objectives. There is, however, always the managerial temptation to deliver what is measured, which might not always be congruent with the underlying objectives. Until recently a difference has been made between accounting practices appropriate for the private sector and those for the public sector. In general, the private sector has developed an accruals-based system targeted principally at the 'bottom-line' profit figure and afflicted over the years with varying degrees of creative accounting.



According to Archibald (1994:144) creative accounting is the term used to describe accounting adjustments made to events that have already taken place. This view is sustained by Naser (1993, as quoted by Archibald, 1994:144), who defines creative accounting as the transformation of financial accounting figures

from what they actually are into what preparers desire by taking advantage of the existing rules and/or ignoring some or all of them.

On the other hand, the public sector has no single target figure and has traditionally relied on a cash-based system, which in itself has areas in which creativity could be exercised, within the rules. Despite the continuing lack of target figures, measured in accounting terms and common to the whole of the public sector, there has been a gradual move towards the adoption of accruals accounting.

The benefits that accruals accounting can provide for public institutions include the following abilities (OECD, 1993 as quoted by Archibald, 1994:1):

- To reflect and provide the basis for accountability for the additional flexibility provided to public managers
- To underpin objectives for a more competitive approach to public sector provision of services
- To facilitate more efficient and effective resource management
- To improve accountability by extending the notion of performance beyond the use and application of cash
- To provide a longer-term focus on the effect of government and management decisions

The following reasons for the use of accruals accounting can therefore be identified (Archibald 1994:2):

- The new accounts and reports will increase the transparency of public institutions' financial management and performance records to Parliament and its committees, and even more widely.
- Accruals accounting will also support the government's general drive towards improved financial management throughout the public services.

At the same time, resource accounting will assist public institutions in managing their finances and resources more effectively, and will facilitate the further development of measures of departmental output and performance.

It is argued that accruals accounting effectively means more openness, improved financial management and better measures of performance and financial control. It is also held that accruals accounting has the advantage of allowing a public institution to be run in a more businesslike manner. In fact, Morrison (1942, as quoted by Archibald, 1994:5) is of the opinion that an organisation does not have to be private in order to be an enterprise. Similarly, an organisation does not have to be private in order to be managed in a businesslike manner. One may, however, speculate that the main political objective for supporting accruals accounting was to increase the pressure on public officials for enhanced performance, by using a form of financial disclosure and reporting that would improve accountability.

## 5 RESOURCE OR PERFORMANCE BUDGETING

In the past, line managers in the public sector administered budgets that they received, rather than managing the resources under their control to optimise outputs and performance (PRC 1998:6). This approach arose from the fact that the budgeting system historically used in South Africa has been incremental budgeting (PRC 1998:18–19). As the name suggests, the focus of “incremental budgeting” is on allocating revenues that become available with little examination of either the allocative efficiency or the technical efficiency of the existing spending. The implicit presumption is therefore that the existing activities are optimal. Until a few years back, reforms had not fundamentally affected the budgeting system, which remains essentially an incremental one.

At the opposite extreme to incremental budgeting is zero-based budgeting, a system where each item of expenditure is newly justified each year. In other words, each year all programmes must still be shown to be relevant to government priorities, effective and efficient. Whereas incremental budgeting has overemphasised continuity, zero-based budgeting underemphasises it, assuming constant flux throughout government. In addition, the process of zero-based budgeting is very costly in terms of staff time.

From 1998/1999, however, the budget of the South African government has been based on a combination of incremental and zero-based principles. A combination of the two systems does include the defects as well as the advantages of both systems. There is, however, another approach that would be preferable to either incremental or zero-based budgeting and would also add value to the new MTEF (Medium Term Expenditure Framework) of budgeting. This approach is referred to as performance-based programme budgeting (PBPB). Variations of this approach are becoming increasingly popular in many other countries throughout the world. It can also be referred to as resource budgeting. According to the OECD (1997:7), Mellett (1998:3) and Likierman (1997:17), resource budgeting uses resource accounting to plan and control public expenditure.

PBPB provides a framework that integrates policy objectives, implementation strategies, required inputs, appropriation of funds, defined outputs and performance measures. Since programmes are linked to a specific policy objective, they can be ranked in terms of their priority. Programme budgeting facilitates efforts to achieve allocative efficiency, because it focuses costing and financial planning on outputs and outcomes, rather than simply on inputs that are not differentiated by the service they help to deliver.

As goals and priorities change over time, programmes can be expanded or phased out and new programmes introduced. A systematic approach to this aspect is the A-B-X budget. As such, the PBPB system should be based on

the A-B-X approach. This approach divides spending allocations into three categories:

- The 'A-base' is the base spending, the cost estimate of existing programmes. This includes cost escalations external to the programme itself, such as inflation and improved conditions of service for public sector employees.
- The second category, the 'B-base', is the sum of the proposed new spending initiatives, either the expansion of existing programmes or new programmes. Included here are cost increases internal to the programme, such as higher minimum standards or extended coverage within the population.
- The last category is the 'X-base', which is the sum of the proposed spending reductions resulting from programme phase-downs and cancellations and from increased efficiencies, for example resulting from programme redesign.

The advantage of the A-B-X budget system is that it differentiates between existing programmes and options for change, and therefore focuses attention on the key allocation decisions that must be made to fund the priorities of government, within the limits of the fiscal framework's expenditure target. Savings or expenditure reductions within one department need not be trapped within that department but can be reallocated across the entire government. Similarly, proposals for new or expanding programmes can be looked at simultaneously, across departments and provinces, which will facilitate the assessment of their overall political and fiscal impact, as well as their priority ranking.

Naturally a balance needs to be found in practice between encouraging departments to achieve marginal efficiency gains, which can be reallocated within their mandate (otherwise the incentive to improve efficiency will be lost), and the principle of reallocation across government as a whole. Generally only economy and efficiency measures that are substantial in size and political impact will find their way into the expenditure reduction component of the draft budget. Departments should retain any residual efficiency savings to address specific priorities, as an incentive to economise further.

The A-B-X budget also underlines the need, within programme budgeting systems, to focus control and evaluation processes on performance measures of outputs and outcomes, rather than on inputs alone. Managers have little incentive to increase technical efficiency within a system that measures only output, since greater efficiency means a lot of resources under their control, as savings are reallocated across departments. Focusing on outputs and outcomes will serve, in contrast, to encourage efficiency gains.

A move towards a PBPB system is not a novel or unproblematic concept. Probably the most ambitious attempt at implementing it was the initiative to implement the Program Planning Budgeting System in the United States of

America in 1965. However, until recently reform experiences have indicated that programme budgeting has largely failed to deliver the goods. The main reason for failure is that the preconditions for success – such as clear objectives, a high level of political support, support for the bureaucracy, and the effective integration of planning and budgeting – have simply not been in place. Such preconditions will clearly need to be established if an effective PBPB system is to be introduced.

## 6 PERFORMANCE MEASUREMENT

In terms of section 38(1)(b) of the Public Finance Management Act (PFMA) of 1999, the accounting officer of a public institution is responsible for the effective, efficient and economic use of public resources. The fact that the PFMA refers specifically to the three E's of performance measurement, namely efficiency, effectiveness and economy, is obviously an indication that performance measurement should receive more attention in future in the South African public service. Accounting officers, through their chief financial officers, have the primary responsibility for the implementation of these performance measures.

Performance measurement should, on the other hand, be addressed as an integral part of the strategic planning process. It is therefore necessary that the accounting officer identify the following during the planning stage of any programme, activity or project:

- The **measures** of efficiency and economy against which the institution's delivery of the programme, activity or project can be evaluated
- The **indicators** of the effectiveness with which the programme, activity or project is achieving the institution's objectives and outcomes
- The **systems and processes** necessary for collecting the information that provides the basis for the measures and indicators relevant to the programme, activity or project implementation

Performance information includes information that assists the accounting officer, the executive authority (relevant minister), the relevant legislature and other users to make informed decisions or to form informed opinions about whether the institution is delivering outputs (goods and/or services) that efficiently, effectively and economically achieve the objectives and outcomes of the institution as identified in its strategic plan.

Measures of efficiency and economy include:

- information about the costs, preferably unit costs where applicable, of delivering outputs
- the quantity delivered during a given period of time

In addition, indicators of effectiveness include:

- information about whether users consider the outputs appropriate to their needs
- the quantity, quality and timeliness of delivering the outputs
- the accessibility of the outputs to the target groups of users
- the sustainability of the results achieved over time

According to Disraeli (1868, as quoted by Archibald, 1994:131), there can be no economy where there is no efficiency. Although this statement was made more than a century ago, it is still true and relevant today.

## **6.1 Measuring financial performance**

After a public institution has prepared a full set of financial statements that meet all the disclosure requirements and have been audited, the financial statements will provide a picture of the institution's financial state of affairs and how it has performed over the period (Archibald 1994:131). In order to understand what has happened, comparisons need to be made with any targets that have been set, as well as with the financial results over time and the financial results of other similar institutions.

The importance of financial targets cannot be overemphasised and should be seen as the primary control over public institutions in the future. It is therefore important that all the financial statements provide comparative information on the previous financial year, unless it is the first year that such information is available. These comparative figures appear in the operating account, balance sheet and cash flow statements as well as in the notes accompanying these financial statements. At the same time, information on the financial targets that a public institution has set should also appear in its statements. On the other hand, comparisons with other institutions will not be shown in the statements but could be included in the annual report of the institution.

### **6.1.1 Overall financial performance**

The key financial targets that cover the overall financial performance in the public sector can be divided into the following four categories (Archibald 1994:132–136):

- break-even
- cost recovery
- return on sales
- return on assets



- **Break-even**

A break-even is achieved when income and costs are exactly equal to one another and no surpluses or deficits can be reported. This situation is also referred to as full cost recovery.

- **Cost recovery**

If an institution cannot achieve full cost recovery or break-even, it may set targets for cost recovery of less than 100 per cent. On the other hand, the target may be set to achieve more than 100 per cent where this is feasible. Cost recovery can be calculated as follows:

$$\frac{\text{Turnover}}{\text{Costs}}$$

However, public institutions operating on a budget are most likely to achieve less than full cost recovery, otherwise they would not require budgetary allocations to balance their cash flow.

- **Return on sales**

Return on sales involves a simple comparison between the surplus and the turnover, which are both disclosed in the operating account. The return on sales for each year can be calculated as follows:

$$\frac{\text{Surplus}}{\text{Costs}}$$

This is also sometimes referred to as the profit margin. In the public sector this type of target would normally be used only when a profit is feasible but where for some reason a target in the form of a return on assets does not make sense.

- **Return on assets**

This type of target focuses on the relationship between the level of surplus and the value of the net assets of an institution. As such, it links information from the operating account and the balance sheet. The return on assets can, however, be calculated as follows:

$$\frac{\text{Surplus}}{\text{Net assets}}$$

The return on assets is sometimes also referred to as the return on capital, and it tends to be used as the primary ratio, since it is often the first ratio

that is calculated to examine the performance of public institutions. In practice, it is more fully calculated as follows:

$$\frac{\text{Surplus before interest}}{\text{Net assets}} \quad \text{or} \quad \frac{\text{Surplus after interest}}{\text{Net assets plus loans}}$$

This calculation is further refined by not using the net assets in the balance sheet at the end of the financial year but by using the average of the assets at the beginning and at the end of the year. Such an approach gives better results, as they reflect the fact that the surplus was earned over the whole year during which the balance sheet values were normally growing. Return on assets is a very common way of setting a target for public institutions.

Some of these targets can be set in terms of historical cost, some in current cost and some in modified historical cost. If comparisons are made with an equivalent private sector organisation, care should be taken to ensure that the cost bases are comparable. The types of targets considered so far are basically options for single measures of the aggregate performance of an institution. Usually only one of them would be used for a single institution.

### **6.1.2 Other measures of financial performance**

There are also other financial measures that can be derived from the financial statements and that supplement the overall measure, concentrating on particular aspects of financial performance (Archibald 1994:136–140). These measures, which are considered to be of importance for the public sector are the following:

- unit costs
- financing and borrowing
- balance sheet management
- **Unit costs**

The unit cost is an indicator of both efficiency (how well inputs are converted into outputs) and economy (the choice and purchase of inputs). It is simply calculated as follows:

$$\frac{\text{Relevant costs}}{\text{Units achieved}}$$

This is not a purely financial measure since it also depends on the non-financial information of the units. However, it is a good measure of efficiency since it compares the input costs with the output achieved. Unit costs calculated on the accruals basis provide a more accurate reflection of all the costs incurred than costs calculated on the cash basis. Because the unit cost involves the non-financial information on units, it is usually



outside the scope of the statutorily required financial statements and is therefore not audited. The audit may, however, be extended to include an assessment of the unit costs.

- **Financing and borrowing**

Public institutions can develop a method to control the burden that they place on the economy, which is referred to as the **external finance limit** (EFL). Usually this method is used for trading funds. The EFL is a cash control that is not based on the accruals base of accounting. As such, it represents the difference between two large cash flows, namely the cash an institution spends (including capital expenditure) and the cash generated from its operations. In practice a relatively small variation in either of these may result in a proportionately larger change in external finance.

This **external financing requirement** (EFR) is met by either borrowing or grant, or some combination of the two. The EFR may be positive or negative. If it is negative, it is an indication that the institution is repaying debt to the relevant treasury or accumulating financial assets. A target for the EFL is normally set in the medium-term budget policy statement, covering the next three years ahead. Public institutions should show an output against the target EFL in their annual reports and not in their financial statements.

- **Balance sheet management**

Financial performance indicators can be used to see how a public institution is managing its balance sheet. As such, the return on assets will show that this has been achieved overall. Individual measures can be calculated to see how the components of the balance sheet have been managed. The commonly used measures are the following:

- **Fixed asset turnover:** The fixed asset turnover gives an indication of the level of fixed assets tied up in an institution. A public institution that uses a lot of fixed assets will have a low value because of the turnover of these assets. This measure can be used to set a target relating to investment in new fixed assets to justify their purchase based on a prediction of a certain increase in turnover. It should, however, not be the only justification for investment.
- **Debtor days:** Debtor days can be calculated as follows:

$$\frac{\text{Trade debtors} \times 365 \text{ days}}{\text{Turnover}} \quad \text{which is equal to} \quad \frac{\text{Uncollected debts}}{\text{Daily turnover}}$$

Such a calculation indicates how long, on average, debtors have been outstanding. It will, however, seem lower than expected if there is a significant proportion of cash sales. The figure of trade debtors represents the position at one particular point in time at the end of the financial year. It can be distorted by the fact that many public institutions may make a holding back payment at the end of March, depending on their own cash flow situation. On the other hand, some public institutions may insist on payment from the public in advance, and would therefore not have any trade debtors or debtors days.

- **Creditor days:** Creditor days can be calculated as follows:

$$\frac{\text{Trade creditors} \times 365 \text{ days}}{\text{Turnover}} \quad \text{which is equal to} \quad \frac{\text{Unpaid debts}}{\text{Daily cost of sales}}$$

Since financial statements do not indicate a cost of sales figure, it may be easier to use the total operating costs, excluding staff costs. This figure may be different from creditor days as defined above, because the figure for trade creditors used in the ratio for creditor days applies only to a calculation at the end of the financial year. The average time taken to pay suppliers may be calculated by determining how long it took to pay individual invoices.

- **Stock days:** Stock days can be calculated as follows:

$$\frac{\text{Stock}}{\text{Cost of sales}} \times 365 \text{ days}$$

This ratio indicates how long stock was kept before used in the service delivery process.

- **Debtors and work in progress investment:** Debtors and work in progress investment is calculated as follows:

$$\frac{\text{Debtors and work in progress}}{\text{Turnover}} \times 365 \text{ days}$$

This calculation will indicate how much is tied up, for a service institution, either in work that is billed to customers and not yet paid or in work that has been started but not yet been completed and billed.

### 6.1.3 Non-financial targets

Public institutions can also set targets for their performance in terms of other measures. These targets may be their quality of service, effectiveness, efficiency or volume of output. Successful management of the institution will depend on the achievement of these non-financial targets as well as the chosen financial

measures. Since they are based on non-financial data, they do not form part of the financial statements but will be in the annual report.

## 6.2 Identification of critical or key performance areas

The following are critical areas for financial management performance in the public sector (DSE 1995a:8–9):

- strategic planning
- formulation of output objectives and business plans
- organisation
- performance measurement
- financial and performance reporting
- management of funds
- management of assets
- management of working capital
- accounting
- provisioning administration (logistics)

These critical or key performance areas should be identified by attending to the objectives that the institution wants to achieve after a certain period of time. The key performance areas of public institutions will differ from one another depending on their individual nature. It is important, however, that the key performance areas of a public institution be identified during the strategic planning exercise and included in the strategic and business plans of the institution.

Once the key performance areas have been identified, it is necessary to determine the key performance measures and key indicators of the Service Delivery Improvement Programme, for assessing the institution's performance, based on the requirements for strategic planning of the Treasury Regulations of May 2000. This will ensure that there is a much clearer relationship between the objectives of the institution and the resources allocated to meet these objectives (Talbot, 1996:22).

## 6.3 Performance indicators (PIs)

Performance indicators will be discussed next by considering a definition of performance indicators, the context of use of performance indicators, a classification of performance indicators, the comparative nature of performance indicators and the specificity of performance indicators.

### 6.3.1 Definition of performance indicators



Performance indicators (PIs) can be considered as by-products of the pressure to secure value for money (Jones 1996:176). In essence, a performance indicator is a numerical figure that can be used in comparison with other figures to indicate the

relative status of some aspects of the performance of the institution in question. However, it is necessary to stress the importance of three main components of the definition:

- It must be numerical although it is not necessarily finance-related.
- It must be used as a valid comparison with others, otherwise it is useless.
- It must be specific enough to enable the appropriate level of management to do something to improve it if necessary.

In general, the performance of the institution or any part of it may be viewed in terms of economy, efficiency and effectiveness. As such, the PIs may be linked to any parts of the value for money chain that was discussed in the third-year level of this module. Some PIs also look very much like costs and are linked to economy and efficiency. Others relate to customer satisfaction or the matching of outputs to planned goals, and are therefore more related to effectiveness.

### **6.3.2 Context of use of PIs**

These indicators normally influence the allocation of resources and the expectation for development in both quality and quantity of future performance (Jones 1996:176). PIs are also intimately related to the management of change. Understandable indicators that can be accepted by the public managers to whom they apply are usually potent levers for motivating staff and changing their behaviour. If the performance indicators of the institution deviate to a large extent from the national norms, public managers at strategic levels may more easily make structural changes to their institutions to ensure both cost-effectiveness and professional conduct.

### **6.3.3 Classification of PIs**

PIs can be classified in terms of a two-by-two matrix deriving from a dimension of internal or external audience and a distinction between indicators that are primarily cost-related (economy and efficiency) and indicators that are related primarily to outcome or quality (effectiveness) (Jones 1996:177). This can be illustrated as follows:

	<b>Internal audience</b>	<b>External audience</b>
<b>Effectiveness</b>	Indicators with a high level of generality, such as 'overall completion rates' for colleges or universities	The same figures may be used by funding providers.
<b>Economy and efficiency</b>	Time taken to clean/polish a certain area of floor	The same figures (if available) would be used by potential tenderers.

Other examples of cost-related indicators include “cost per dustbin emptied” (local government) or “cost per patient-day” (Department of Health). At the same time, examples of output, outcome or client satisfaction indicators may include “the number of errors or complaints per 1 000 transactions” (from any part of the public sector) or “reported cases solved” (police service).

#### **6.3.4 Comparative nature of PIs**

It is important to keep in mind that a PI on its own is meaningless (Jones 1996:177–178). Performance indicators must therefore be placed in a comparative context before having either meaning or potential as a tool for management. As such, the following three main comparisons may be made:

- A comparison with a corresponding indicator from another similar institution
- A comparison with the same indicator derived from within the same institution and covering a different period of time, for example last year’s figures or a run of figures over a three-year period
- A comparison with some norm or standard either accepted within a particular culture or encouraged or imposed by some higher authority

When these comparisons are made, it is important to ensure that there is strict comparability in how the figures have been collected and the subsequent calculations made. In other words, like must be compared with like, and it is often by no means certain that all data have been collected in the same manner. It is therefore necessary to query the methodology that was previously used, especially when two similar indicators show any serious degree of divergence.

#### **6.3.5 Specificity of PIs**

A balance should be obtained between those PIs that focus on relatively minor aspects of an institution’s work, such as the time per square metre for floor polishing, and those that are very general and cover a whole host of its activities, such as the overall completion rate for colleges and universities (Jones 1996:178). Although both are relatively easy to obtain and calculate accurately, the first type has applicability to only a very small section of the institution. Even if they are “owned” and improved, they are unlikely to enhance the overall performance of the institution significantly.

Although the second type of indicator is much more significant in institutional terms, they may not be owned by any group that focuses specifically enough to do anything about it. It is therefore necessary that public managers perform a delicate balancing act between specificity and generality to ensure that indicators are specific enough to be owned by groups who can do something about them, while avoiding indicators that are so specific that they can be tied to individuals. Such indicators have their uses, but more in the context of reward and discipline.

In general, the development of indicators is often allocated to an information management section or department that is staffed by experts in computers, statistics or both. It is therefore imperative that the outputs of any such section should be intelligible, directed to the right people and interpreted by managers who understand the implications of the indicators.

## **7 PERFORMANCE CONTRACTING**

One of the characteristics of a management-for-results approach is that the accounting officer or chief executives are on term contracts with ministers supported by performance agreements negotiated by the Public Service Commission (DSE 1995a:2). The performance contract referred to here can be defined as an agreement between the minister and the accounting officer or the chief executive that allows for monitoring of the accounting officer's performance against expectations. It confirms the institution's priorities and provides a framework for the performance agreements of the executive team, thus supporting the attainment of the organisation's objectives.

In terms of section 36(5) of the Public Finance Management Act (PFMA) of 1999, the employment contract of an accounting officer of a public institution must be in writing and, where possible, include performance standards. It is, however, important that the provisions of sections 38 and 42, as may be appropriate, are regarded as forming part of each such contract. These sections deal specifically with the general responsibilities of accounting officers as well as with the accounting officers' responsibilities when assets and liabilities are transferred.

Traditionally accountability in the public sector has been one of stewardship, which has meant being accountable for the spending of funds and therefore being accountable for the use of inputs (South Africa 1996:8–10). To a certain extent this confined accountability largely to cash management. However, the concept of accountability needs to be broadened to cover the full range of resources under the control of spending agencies and to include the additional dimension of accountability for performance.

Since performance contracts and agreements form part of the accountability chain, it is vital to give attention to the following elements of this chain:

### **7.1 Accountability of ministers and MECs to their legislatures and the community**

Ministers and MECs are accountable through their legislatures to the community for the performance of their spending agencies. This includes the proper allocation and use of resources in the implementation of government policies and

priorities as well as the delivery of quality, value-for-money goods and services. In defining the accountability to the public of ministers and MECs, a guarantee of service delivery will be made available to the community, specifying inter alia:

- who the customers of a spending agency are
- what goods and services the spending agency will provide
- the quality standards that will apply to services delivered, and how customers can register complaints or make suggestions about these services

## **7.2 Performance agreements between the minister/MEC and each head of a spending agency**

The performance agreement between the minister/MEC and each accounting officer should identify the key accountabilities to which the accounting officer will add value in order to achieve Spending Agency Objectives (SAOs). As such, the performance agreement provides a framework for the performance of the senior executive, thus supporting the attainment of spending agency objectives. Regular feedback and review will ensure that any changes in government priorities and directions are accommodated in the agreement and that government objectives and policies are addressed.

## **7.3 Performance contracts between the head of a spending agency and senior executive officers**

These performance contracts are similar to the performance agreements between the minister/MEC and the heads of spending agencies, but they are more limited in scope as they apply only to that part of the spending agency's operations for which the senior executive officers have assumed responsibility. They are linked to the SAOs specified in the strategic plan, and they incorporate accountability for the outcomes of the business plan in the area of responsibility.

## **7.4 Performance assessment of staff**

The staff of each spending agency is linked to the accountability chain through the spending agency's performance management system. This will ensure that a systematic approach is being taken towards the management of individual performance by linking the spending agency's business plan to the development of individual work plans and the staff appraisal process. An effective system of accountability for performance should, however, possess the following important attributes:

- a mechanism to ensure that the linkage between policies, priorities and the budget is a formal part of the process



- full linkage and consistency between performance agreements or contracts and the spending agency's strategic and business plan (at each level within a spending agency)
- definition by the accountability process of the performance requirements (at each level within a spending agency), including actions and outputs to be provided and the time-frame in which they will occur
- designation of persons responsible for the delivery of outputs
- regular reporting requirements to enable an assessment to be made of performance achieved against targets set
- assessment and review of performance and feedback into the planning process
- recognition of the fact that the role of the public sector must deliver goods and services to the clients of government spending agencies, rather than simply carrying out a series of traditional tasks and processes
- movement from assessing inputs (money and staff) and processes to focusing on outputs and outcomes

Performance management, based on the performance contract and agreements, is the process of planning, monitoring, reviewing and making decisions about performance. It identifies, evaluates and develops staff members' work performance to achieve spending agency objectives. Performance management will benefit employees through recognition, performance feedback, catering for work needs and offering career guidance. As such, the purpose of performance management and contracting can be described as the following:

- to maximise the achievement of spending agency objectives set out in the strategic and business plans, through promotion of a results-oriented work culture that identifies and addresses outstanding, satisfactory and poor performance
- to establish a structure for improving staff members' performance by providing non-discriminatory, job-related performance criteria and constructive feedback from supervisors on perceived strengths and areas for further development
- to identify training, developmental and career needs of employees in order to facilitate workforce planning to achieve spending agency objectives (this includes the concept of continuing education and the extension of knowledge and skills)
- to foster a workforce that is innovative, versatile and responsive to varying needs
- to provide relevant information about the achievement of the objectives of spending agencies



In essence, the performance management system, based on performance contracts, will require the following:

- the development of a work plan for each employee with defined tasks and objectives that are linked to and support the spending agency's strategic and business plans
- agreement between employees and their supervisors on the results that must be achieved
- assessment of employees' performance against agreed objectives, using appropriate performance indicators
- structured feedback to employees on their performance
- recognition of outstanding performance

In terms of resolution 13 of 1998 of the Public Service Coordinating Bargaining Council, performance agreements can be concluded with senior management (DPSA 1999:71). A senior manager who is not head of a department must sign an agreement with his/her head of department. Measures included in the Public Service Laws Amendment Acts of 1997 and 1998 and the Public Service Regulations of 1999 will further supplement the resolution. Collectively they will form the regulatory framework in terms of which performance agreements must be implemented and managed.

## 8 PERFORMANCE AUDITS



Performance auditing is a natural extension of financial auditing in its procedures and purpose (Malan, Fountain, Arrowsmith & Lockridge 1984:9–10). However, it focuses on economic actions and events as well as the overall performance of the entity or function under review. Performance auditing can therefore be defined as a systematic process of objectively obtaining and evaluating evidence regarding the performance of an institution, programme, function or activity. The evaluation is made in terms of the economy and efficiency of operations, effectiveness in achieving desired results and compliance with relevant policies, legislation and regulations, for the purpose of ascertaining the degree of correspondence between performance and the established criteria, and communicating the results to the interested users. It is therefore important that the performance audit function provide an independent, objective, third-party review of management's performance and the degree to which the performance of the audited entity meets predetermined expectations.

Performance audits, also referred to as operational audits, include economy and efficiency audits as well as programme results audits (Defliese, Jaenicke, O'Reilly & Hirsch 1990:31; Gauthier 1995:57). The purpose of economy and efficiency audits is the following:

- to determine whether the institution is acquiring, protecting and using its resources (such as personnel, property and funds) economically and efficiently
- to determine the cause of inefficiencies or uneconomical practices
- to determine whether the institution has complied with laws and regulations concerning matters of economy and efficiency

Programme results audits, on the other hand, include determination of the following:

- the extent to which the desired results or benefits established by the legislature or other authorising body are being achieved.
- the effectiveness of institutions, programmes, activities or functions.
- whether the institution has complied with laws and regulations applicable to the programme.

In a performance audit, the auditor seeks answers to one or both of the following questions (Gauthier 1995:48):

- is management performing its duties economically and efficiently?
- are programmes achieving their intended purposes?

Performance auditing shares many of its goals and techniques with financial auditing (Gauthier 1995:49). There are, however, some very important differences between the two types of auditing. The scope of the typical financial statement audit includes all the transactions and events affecting a government's financial statements. Performance audits, on the other hand, are typically much more narrowly focused, often on a single programme, institution or activity. Financial statement audits also enjoy the benefit of widely accepted criteria (such as generally accepted or recognised accounting practice) that define "fair representation" of the financial statements. However, similar widely accepted standards of what constitutes efficient or "effective" performance do not exist for performance auditing. Accordingly, an important part of the performance auditor's task is to develop persuasive criteria of efficiency and effectiveness to apply to each audit arrangement. Eventually the financial statement auditor's report is limited to commenting on the financial report, which is a management document, while the entire report on a performance audit is an auditor's document.

A strong emphasis on performance auditing by public institutions should be encouraged (DSE 1995b:21). Public institutions should therefore move towards a balanced approach between financial compliance auditing and performance auditing, involving a greater proportion of performance auditing by internal audit components than was the case in the past.

Historically, financial compliance auditing has focused on the flow of accounting information through computer-based and other systems, on controls over it and

on the reliability of the accounting records. Performance auditing, on the other hand, is much broader, since it focuses on the institution's entire operating procedures and practices. It extends to non-financial activities such as line functions and personnel matters that would not normally receive in-depth coverage in a strict financial audit.

As such, the aim of performance auditing is to provide an independent appraisal of such activities by evaluating aspects of the systems of internal control outside the traditional financial area. This approach will have the following benefits:

- Providing senior management and the audit committee with objective feedback on the quality of the institution's internal control system and the quality of its performance.
- Providing line managers with more detailed feedback on the quality of their control systems and their unit's performance.
- Encouraging line managers to improve performance by taking actions to correct deficiencies in control and identified performance problems.

The manual on internal audit of the DSE (1995b:21–22) states as follows:

It is important that the internal auditor also determine whether the objectives of every unit within a public institution are clearly formulated and defined in a measurable way, including those of the finance and administrative units. Although this is a difficult and complex matter that could require a different set of criteria for each objective, it is nonetheless important in order to establish the necessary operating standards. Only then can deviations be determined and corrective actions be taken. Once these criteria have been determined it will be possible to review operations or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned. The findings, together with recommendations to improve performance and accountability, can then be supplied to management.

From an internal audit perspective, other audit-related services covered by performance auditing include the following (DSE 1995b:22):

- reporting directly at regular intervals to the accounting officer on the result of any appraisal, inspection, investigation, examination or review made by the internal audit component
- ensuring that internal audit is flexible in the face of constant change, through open communication with staff and regular consideration of the best use of available resources
- assisting managers to prevent and detect fraud as well as carrying out fraud investigations

- carrying out special investigations into value for money, without discharging programme managers of their responsibilities in this regard
- carrying out special operational or project audits
- carrying out impact assessments
- managing the relationship with external auditors
- assisting management to design and implement controls
- educating managers in performance management and its underlying concepts
- assisting managers to implement the management process effectively and efficiently
- assisting managers in self-assessment of the quality of their controls

The manual on internal audit (DSE 1995b:22–23) continues:

Financial compliance and performance auditing are not mutually exclusive. Recommendations for operating deficiencies are frequently by-products of compliance audits. The system of internal control operates to mitigate the risks which flow from all of a department's activities, not just from financial activities. Both performance and financial compliance auditing require a thorough knowledge of what is being done, how it is being done and why it is being done.

The rate of progression towards performance auditing for a given level of internal audit resources, depends upon the progress achieved in improving the quality of internal control in the areas covered by the more traditional financial compliance audit.

According to Drucker (as quoted by Sawyer 1981:794), performance audits deal with performance in the following four areas:

- **Performance in appropriating capital:** Such an audit determines what has happened on specific projects after capital spending has been approved. It also measures results against expected outcomes.
- **Performance on people's decisions:** This measures the performance of people against what was expected of them when they were employed.
- **Innovation performance:** This measures the outcome of research efforts after one to five years, based on what was expected at the inception.
- **Planning performance:** This determines how well management predicted and prepared for the future.

Performance auditing requires varied and technical skills. Particularly useful to auditors doing performance audits is a background in the following:

- computerised analytical techniques, such as linear programming
- decision analysis, including regression and correlation, inventory models and cost-benefit analysis
- operations research techniques
- legal analysis

Since no single person has skills in all these areas, a team of professionals whose skills are complementary is usually put together.

## 9 PERFORMANCE REPORTING

Performance reporting will be discussed briefly by focusing on a definition of this concept and the detail of reporting on the evaluation of performance.

### 9.1 Definition



Accruals accounting reports what was achieved as well as the resources used in achieving the outputs, irrespective of when the cash was paid (Archibald 1994:2). The OECD (1997:7) therefore defines resource accounting as a set of accruals accounting techniques for reporting on the expenditure of central government and a framework for analysing expenditure by departmental aims and objectives, relating those to outputs wherever possible.

### 9.2 Reporting on the evaluation of performance

It is necessary that the accounting officer of a public institution establish procedures according to which management reports are provided to him/her at least every three months about programme, activity and project performance based on the measures and indicators discussed earlier (DSE 1999a:36–37). These reports should facilitate management's effective monitoring and evaluation of the following:

- The institution's efficiency and economy in delivering the programmes, activities or projects under its control.
- The effectiveness with which the programmes, activities or projects are achieving the objectives and outcomes.
- The options to improve the economy, efficiency and effectiveness of the institution's performance.

At the same time, the accounting officer should prepare and deliver quarterly reports to the executive authority (relevant minister) about his/her evaluation of the institution's performance, based on the information required for the management's reports. These quarterly reports should also address the following aspects:

- Progress in relation to new programmes, activities and projects proposed in the institution's strategic plan for implementation during the financial year.
- Other matters in relation to the institution's strategies, outputs and objectives or outcomes that the accounting officer considers it necessary or appropriate to advise the executive authority about.

These quarterly reports to the executive authority should form the basis for the accounting officer's report of the institution's performance for inclusion in the annual report of activities that is required in terms of section 40(1)(d)(l) of the PFMA.

### **9.3 Reporting on non-financial performance**

As far as performance reporting is concerned, public institutions must also report on non-financial performance regarding the following issues (South Africa 1996:25):

- Progress in meeting objectives as set out in the strategic plans of individual spending agencies.
- Objectives and service performance as set out in the estimates of expenditure and business plans of individual spending agencies.
- Services offered and standards compared to objectives as set out in the guarantee of service delivery.
- Performance in accordance with agreements entered into by chief executive officers and senior members of management.

## **10 CONCLUSION**

It should be evident from the discussions in this unit that it is important to realise that performance management entails various components. As a whole, these components contribute to sound performance management in the public sector. All of these components must therefore be present in a system of performance management, otherwise proper performance management will not be possible. It should, however, be clear that people or employees play an important role in performance management, and that it is not all about determining measures and the proper utilisation of funds. In fact, it is these employees of public institutions who must be able to account to Parliament and the public about their performance and the accomplishment of the predetermined objectives.



## 11 SELF-ASSESSMENT

1. Describe the key principles of performance management. (8)
2. List the regulatory framework of performance management. (20)
3. Describe the role of accruals and resource accounting in performance management. (20)
4. Describe and explain how performance can be measured. (20)
5. Describe the importance of performance contracting in the public sector. (25)
6. Describe the purpose of and reason for performance auditing. (25)
7. Describe performance reporting as part of the performance management process. (15)

## **12 FEEDBACK ON SELF-ASSESSMENT**

1. You should have described the key principles of performance management by applying the knowledge acquired in section 1 of this unit.
2. You should have described the regulatory framework by applying the knowledge acquired in section 2 of this unit.
3. You should have described the role of accruals and resource accounting in performance management by applying the knowledge that you acquired in section 4 of this unit.
4. You should have described and explained how performance can be measured by applying the knowledge that you acquired in section 6 of this unit.
5. You should have described the importance of performance contracting in the public sector by applying the knowledge that you acquired in section 7 of this unit.
6. You should have described the purpose and reason for performance auditing by applying the knowledge that you acquired in section 8 of this unit.
7. You should have described performance reporting as part of the performance management process by applying the knowledge that you acquired in section 9 of this unit.



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# FINANCIAL AND PERFORMANCE REPORTING IN THE PUBLIC SECTOR

UNIT

**7**

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## ROUTE MAP

Use the route map below to determine where you are within the syllabus and where this study unit fits into the module:



## LEARNING OBJECTIVES

After studying this unit, you should be able to:

- explain the statutory requirements for financial and performance reporting
- explain the statutory requirements for financial statements
- explain the basis on which financial statements are consolidated in the public sector
- describe the compilation of financial statements
- explain who the users of the financial statements of public institutions are
- explain and describe how financial statements can be analysed and interpreted
- explain the limitations of financial statements
- describe financial and performance reporting in the public sector
- explain how accountability can be achieved through reporting

## 1 INTRODUCTION

In the past, financial management consisted of centrally prescribed bureaucratic rules that allowed little use of management's discretion in the public sector. This was in fact financial administration and not financial management, regulating the ways in which inputs were used rather than considering the outputs that those inputs were intended to achieve. This approach did not clearly define responsibilities, resulting in poor accountability. Accounting officers adopted a passive approach to their budgets during the financial year and did little to avoid overspending or underspending. This situation was compounded by delays in the production of financial information, which was often available only a few months after the end of the financial year. Eventually value for money and accountability were undermined.

The Public Finance Management Act (PFMA) of 1999 addresses this problem by enabling accounting officers to manage but making them more accountable for the resources they use. It establishes clear lines of accountability together with

broad frameworks of best practices for managers to adopt or, where necessary, to adapt. A crucial aspect will be the improvement of the quality of information available to managers. The Act stresses the need for regular monthly monitoring reports to be produced by the accounting officer for submission to the Minister or MEC and the relevant treasury. These reports will focus attention on performance against budget and service delivery plans and will alert managers where remedial action is required. In addition, these reports will be consolidated and published monthly in the national Government Gazette, in line with international best practice. These monthly reports will facilitate the compilation of the year-end financial statements and annual reports. The reduced time-frames for audit procedures will also strengthen accountability to Parliament.

To obtain a better understanding of financial and performance reporting in the public sector, the various aspects of financial and performance reporting will be discussed next, including the compilation and analysis of financial statements, which forms a large and important component of reporting.

## **2 STATUTORY REQUIREMENTS FOR FINANCIAL AND PERFORMANCE REPORTING**

The statutory requirements for financial and performance reporting will be discussed by focusing on the requirements of the PFMA of 1999 and the requirements of the Treasury Regulations of May 2000.

### **2.1 Requirements of the PFMA of 1999**

The Public Finance Management Act of 1999 stipulates the reporting responsibilities of the executive authority (the relevant minister) and the accounting officers of a public institution. These reporting responsibilities are indicated in the table of the annexure at the end of this unit, which includes the time-frames for reporting as well as the relevant sections in the PFMA.

### **2.2 Requirements of the Treasury Regulations of May 2000**

Chapter 18 of the Treasury Regulations of May 2000 gives an exposition of the requirements applicable to monthly and annual reports. These requirements are quoted verbatim in what follows to ensure completeness of content:

**18.1 Cash flow [Section 40(4)(a) of the PFMA]**

- 18.1.1 The accounting officer must annually submit to the relevant treasury a breakdown of anticipated revenue and expenditure in the format determined by the national Treasury, no later than the last working day of February preceding the financial year to which it relates.
- 18.1.2 Provincial treasuries must submit to the national Treasury by the 15th working day of February, projections of their expenditure, revenue and borrowings, in a format determined by the national Treasury.
- 18.1.3 Once such amounts have been approved, modified as necessary after consultation with the relevant treasury, the accounting officer may not draw from the revenue fund more than the amount approved for a month, without prior written approval from the relevant treasury.
- 18.1.4 If the accounting officer deems it necessary to adjust the approved projections, the proposed adjustments must be motivated to the relevant treasury for evaluation against the availability of funds in the Exchequer.

**18.2 Monthly reports [Section 32(2) and 40(4)(b) of the PFMA]**

- 18.2.1 In terms of subsections 40(4)(b) and (c) of the Act, the accounting officer must submit to the relevant treasury and executive authority within 15 days of the end of each month, information on:
  - (a) the actual revenue and expenditure for that month, in the format determined by the national Treasury;
  - (b) projections of anticipated expenditure and revenue for the remainder of the current financial year in the format determined by the national Treasury; and
  - (c) any material variances and a summary of actions to ensure that the projected expenditure and revenue remain within the budget.

/continued ...



- 18.2.2 A provincial treasury must submit a statement to the national Treasury on actual revenue and expenditure with regard to its revenue fund before the 22nd day of each month in the format determined by the national Treasury. Such a statement must include a certificate to the effect that the information supplied has been verified by the head official of the provincial treasury.

### **18.3 Quarterly reports**

- 18.3.1 Information on division of revenue grants must be reported in terms of the annual Division of Revenue Act.
- 18.3.2 The accounting officer effecting transfer payments must submit a report to the relevant treasury within 15 days after every quarter, outlining all the funds transferred per organisation up to the end of that quarter.

### **18.4 Contents of annual reports**

- 18.4.1 In preparing the annual report of an institution, the accounting officer must:
- (a) in the case of a department or trading entity, comply with the requirements prescribed in Chapter 1, Part III of the Public Service Regulations, 1999;
  - (b) include, after 1 April 2002, information about the institution's efficiency, economy and effectiveness in delivering programmes and achieving its objectives and outcomes against the measures and indicators set out in any strategic plan for the year under consideration;
  - (c) include information on the measurement of the institution's performance for the past financial year as required by section 40(1)(d)(i) (of the PFMA);
  - (d) include information on transfer payments per organisation for the entire financial year as well as a report on compliance with section 38(1)(j) of the Act (PFMA);
  - (e) include any additional information required by Parliament or the provincial legislature;

/continued ...

- (f) report on the use of foreign aid assistance, detailing the source and intended use of the assistance (including the value of any aid-in-kind in rand), performance information on the institution's use of the assistance and any pending applications for assistance; and
- (g) a report from the audit committee commenting on the effectiveness of internal control in the institution, as required by paragraph 3.1.11(b).



**Take note:** Chapter 1, Part III J of the Public Service Regulations of 1999:

## **J. Managerial Review and Oversight**

- J.1 When a departmental budget is presented to the relevant legislature, the executing authority shall, in terms of section 92(3)(b) or 133(3)(b) of the Constitution, publish an annual report to the relevant legislature, the media and the public. She or he shall include the following information:
  - J.2 Planning and service delivery
  - J.3 Organisation
  - J.4 Job evaluation
  - J.5 Remuneration
  - J.6 Affirmative action, recruitment, promotions and termination of services
  - J.7 Performance management and skills development
  - J.8 The number and nature of incidents of injury, illness and death occurring in the course of official duty or in the work environment
  - J.9 The number and subject matter of collective agreements entered into
  - J.10 Sick leave
  - J.11 The number of employees discharged due to ill-health
  - J.12 The first report in accordance with regulation III J must be presented to the relevant legislature during the financial year 2001/2002, together with the departmental budget for that financial year



**Important:** To understand each of the above points that must be included in the annual report, it is necessary that this part of the Public Service Regulations be studied in more detail:

### **18.5 Additional annual reporting requirements for departments controlling trading entities and public entities**

- 18.5.1 A department's annual report must include a list of trading entities and/or public entities controlled by the department, together with:
- (a) an indication of the legislation under which the trading and/or public entities was established;
  - (b) a statement of the functions of each trading and/or public entity; and
  - (c) the accountability arrangements established between the accounting officer and the management of the trading or public entity.

## **3 FINANCIAL STATEMENTS**

The financial statements of public institutions will be discussed by focusing on the statutory requirements for these as well as the basis for the consolidation of financial statements and the compilation of financial statements. The users of the financial statements of public institutions as well as the analysis and interpretation of financial statements and their limitation will also be addressed.

### **3.1 Statutory requirements for financial statements**

In terms of sections 40(1)(b) and 55(1)(b) of the PFMA, the accounting officer or the accounting authority of a public institution must prepare financial statements for each financial year in accordance with generally recognised accounting practice. These financial statements must be submitted within two months after the end of the financial year to the Auditor-General for auditing and to the relevant treasury to enable that treasury to prepare the consolidated financial statements in terms of section 8 or 19 of the PFMA.

Thereafter the audited financial statements for that financial year must be submitted within five months after the end of the financial year to the relevant treasury and the executive authority, together with the annual report on the activities of the public institution and the Auditor-General's report on those statements. The financial statements and the annual report must present the state of affairs of the public institution and its business fairly as well as

its financial results, its performance against predetermined objectives and its financial position at the end of the financial year concerned.

In terms of sections 8 and 19 of the PFMA, the National Treasury and the provincial treasuries have the responsibility to prepare consolidated financial statements in accordance with generally recognised accounting practice for each financial year. These consolidated financial statements must be prepared by the National Treasury and the provincial treasuries in respect of national and provincial departments, public entities, Parliament and the provincial legislatures, constitutional institutions, the South African Reserve Bank and the Auditor-General. The consolidated financial statements must be submitted to the Auditor-General for audit within three months after the end of the financial year. The Minister of Finance and MECs for finance in the provinces must submit the consolidated financial statements and the audit report on those statements within one month after being received from the Auditor-General to Parliament for tabling in the National Assembly and the Council of Provinces (two houses of Parliament).

The consolidated financial statements must be made public when submitted to Parliament and the provincial legislatures. If the Minister of Finance or MECs for finance in the provinces fail to submit the consolidated financial statements and the Auditor-General's audit report to Parliament or the provincial legislatures within seven months after the end of the financial year, they must submit a written explanation to Parliament in which they explain the reasons why the statements and report were not submitted. At the same time the Auditor-General may issue a special report on the delay.

Based on sections 40(1)(b) and 55(1)(b) of the PFMA, the Treasury Regulations (TR) of May 2000 require that annual financial statements must be compiled for the financial year ending 31 March 2001 (paragraph 18.4 of the TR). As such, the following reporting standards comprise **generally recognised accounting practice**, and must be adhered to unless otherwise approved by the National Treasury:

Reporting entity	Generally recognised accounting practice
National and provincial revenue funds	<p>Annual financial statements must consist of:</p> <ul style="list-style-type: none"> <li>(a) a statement of liabilities and financially related assets</li> <li>(b) an income statement</li> <li>(c) a cash flow statement</li> <li>(d) notes to the annual financial statements</li> <li>(e) a report on the financial position of and performance by the treasury</li> </ul>
/continued ...	

Reporting entity	Generally recognised accounting practice
	<p>(f) such other statements as may be determined by the Accounting Standards Board</p> <p>The annual financial statements must be prepared on a cash basis and must be accompanied by the audit opinion of the Auditor-General.</p> <p>The annual financial statements must, by means of figures and a descriptive report, explain any other matters and information material to the affairs of the relevant revenue fund</p>
Departments, Parliament and provincial legislatures	<p>Annual financial statements must consist of:</p> <ul style="list-style-type: none"> <li>(a) a balance sheet</li> <li>(b) an income statement</li> <li>(c) a cash flow statement</li> <li>(d) notes to the annual financial statements</li> <li>(e) such other statements as may be determined by the Accounting Standards Board</li> </ul> <p>The annual financial statements must be prepared on a cash basis and must be accompanied by the audit opinion of the Auditor-General.</p> <p>The annual financial statements must, by means of figures and a descriptive report, explain any other matters and information material to the affairs of the institution.</p>
Trading entities and Constitutional institutions	<p>Annual financial statements must consist of:</p> <ul style="list-style-type: none"> <li>(a) a balance sheet</li> <li>(b) an income statement</li> <li>(c) a cash flow statement</li> <li>(d) notes to the annual financial statements</li> <li>(e) such other statements as may be determined by the Accounting Standards Board</li> </ul> <p>The annual financial statements must be accompanied by the audit opinion of the Auditor-General or the relevant auditor (in the case of public entities).</p> <p>Unless otherwise approved by the National Treasury, the annual financial statements must, in conformity with statements of Generally Accepted Accounting Practice (GAAP) issued by the South African Institute of Chartered Accountants, fairly represent the financial position, financial performance and cash flow of the institution at the end of the financial year concerned.</p> <p>The annual financial statements must, by means of figures and a descriptive report, explain any other matters and information material to the affairs of the institution.</p>

### 3.2 Basis for the consolidation of financial statements

A core general ledger that is computerised and maintained by the National Treasury is also used for annual consolidation purposes. Reporting formats and input protocols are prescribed to all spending agencies and other entities that form part of the government financial reporting entity. Spending agencies and entities that are owned by the government are combined by adding together corresponding assets, liabilities, revenue and expenses. Transactions and balances between entities are eliminated on consolidation. All other entities under the control of the government financial reporting entity are consolidated by recording the government's share of the net assets, including asset valuation movements and surpluses and deficits. Unrealised surpluses and deficits on inter-entity transactions not carried out on an arm's length basis are eliminated. Other inter-entity transactions and balances are not eliminated.

### 3.3 Compilation of financial statements

When annual financial statements are compiled, it is necessary in most cases to compile an income statement, a balance sheet, a cash flow statement, such other statements as may be determined in future by the Accounting Standards Board and notes to the annual financial statements. It is, however, important that attention be given to the requirements, as set out in the Treasury Regulations of May 2000, for the compilation of monthly and annual reports and their expected content. At the same time, it is important to remember that these financial statements must be compiled in accordance with **generally recognised accounting practice** (GRAP).

Currently the Treasury Regulations indicate that the **cash basis of accounting** constitutes generally recognised accounting practice, but it is expected that in future the **accruals basis of accounting** will constitute generally recognised accounting practice. Since the SA Public Service has been using the cash basis of accounting for more than the last decade, it cannot be expected to change overnight to an accruals accounting system. In most other countries where the public service has had to change to an accruals accounting system, it has takes a number of years to accomplish.

Some of the financial statements that must be compiled according to generally recognised accounting practice (GRAP) are the income statement, balance sheet and cash flow statement. Financial statements are not ledger accounts, however, but are drawn up separately from the ledger accounts (Hepworth 2003:160). Public managers are interested in a periodic summary of the results of all transactions concluded during a specific period rather than in the results of each individual transaction (Faul et al 1994:60). Accordingly, regular reports on the information arising from the transactions are furnished by means of the financial statements. A decline in the frequency and regularity of the provision of these statements will tend to produce a corresponding decrease in the degree of control exercised by the management and the executive authority.

Determining the financial result and position of an institution at regular intervals is also essential for the purpose of internal management and control (Faul et al 1994:38). This makes it possible for management to make timely judgements and to take decisions about future actions based on those judgements. The intervals between successive determinations of the financial results depend upon the requirements of the control process. Certain aspects of an institution's activities may necessitate the continuous measurement of the position or result, while in other cases it can be determined monthly or even annually.

It is, however, general practice and obligatory as far as public institutions subject to legal requirements (PFMA) are concerned that the financial result and position of an institution be determined at least every 12 months and be communicated in the form of a set of financial reports to external interest groups. This period of 12 months, which ends on the same date each year, is known as the institution's financial year. As far as public institutions at national and provincial government levels are concerned, the **financial year** starts on the first day of April and ends on the last day of March during the next year (for example 1 April 2001 to 31 March 2002). At local government level the financial year runs from the first day of July until the last day of June the following year. The year-end dates in the public sector are therefore 31 March and 31 June.

### **3.3.1 Income statement**

The financial result – that is, the surplus or deficit for the relevant financial period – can be determined from the income statement (Faul et al 1994:38). The financial results can therefore be measured in accounting terms by determining the difference between income and expenses for the financial period. The period covered by an income statement is known as the financial period. A **financial period** is the period for which the financial results of an institution are determined. An income statement can therefore be compared with a film covering the events during a specific period. All income and expense items that are accounted for in the financial statements for a specific period should therefore be included in the income statement for that period.

In practice, therefore, the financial history of an entity will consist of a series of income statements reflecting the surplus or deficit for each separate financial period. The income reflected in the income statement is the value that accrues to the institution in the normal course of its operations in exchange for services rendered, for goods sold or for placing its assets at the disposal of third parties. It is, however, necessary to distinguish between income, gross income and net income.

Gross income is the total income earned. Net income is the difference between gross income and expenses, and is therefore synonymous with a surplus. The term 'income', as it is used here, refers to gross income. In practice, the term 'income' is also sometimes used to mean net income. However, the realisation



principle prescribed two conditions for the recognition of income, namely that it must be earned and realised. Income is earned when the party giving value has completed its obligation towards the party receiving value. In the case of services, the rendering thereof must be completed before the income can be recognised. To be realised, income must be measurable and its recoverability must be reasonably certain.

On the other hand, a public institution incurs expenditure when it exchanges one value for another. An institution therefore incurs expenditure when it purchases goods or services. Expenditure can be incurred on assets or expenses. Expenditure on an asset includes the acquisition of value that has not been consumed. For example, if the institution buys a machine for R100 000 cash, the value tendered is R100 000, but a machine worth R100 000 has been acquired in exchange. Conversely, an expense is an expenditure that has been consumed. If one assumes that the institution is paying a provider R500 for stationery, the institution will have tendered R500 cash for value that will be consumed.

### **3.3.2 Balance sheet**

The financial position of an institution – that is, the state of its assets, liabilities and own capital at the closure of the relevant financial period – can be determined from the balance sheet. The date on which the balance sheet is drawn up is called the balance sheet date. The **balance sheet date** is usually determined to coincide with the end of the financial period when the financial position of the institution is determined (Faul et al 1994:38). A balance sheet may therefore be viewed as a snapshot of the financial position at a particular moment in time.

The financial history of an institution will therefore consist of a series of balance sheets showing the financial position of the institution at the end of each financial period. These balance sheets will reflect the assets belonging to the institution at that specific time as well as the liabilities of the institution (Faul et al 1994:23). The difference between the assets and the liabilities reflected in the balance sheet represents the institution's own capital. The financial position of a public institution can, however, be influenced and changed in the following ways (Faul et al 1994:47):

- An increase in an asset can lead to an equal increase in own capital.
- An decrease in an asset can lead to an equal decrease in own capital.
- One asset can decrease while another asset increases simultaneously by an equal amount.
- One own capital item can decrease while another increases simultaneously by an equal amount.

Other factors can also influence the financial position of a public institution. One of the most common examples is the **depreciation** of assets over the course of time.



Depreciation is a measure of wear and tear, consumption or other loss of value of fixed assets that arises as a result of use, the lapse of time, or obsolescence due to technological advancement or changes in the market. Depreciation is allocated to financial periods in such a manner that a reasonable amount is set off in each financial period during the expected useful life of the asset.

### **3.3.3 Cash flow statement**

Information about the events and transactions that affect the cash position of a public institution is reported in a statement called a cash flow statement (Faul et al 1994:492; Melville 1997:270). Until recently it was custom virtually throughout the world to produce a “source and application of funds” statement. Although there is a slight resemblance between such a funds statement and the cash flow statements, the funds statement is concerned with the flow of funding of an institution rather than focusing on the end result or the cash balance. It would be compiled by a comparison of the balance sheets at the beginning and end of the year, making some adjustments. It would tend to be nothing more than a list of changes in balances which was not of great benefit to users. The cash flow statement, on the other hand, contains much the same information but is set out in a more logical and understandable manner.

While the basic financial statements – namely the income statement and balance sheet – contain a great deal of information that is useful to management and investors, they do not answer all the questions that could be raised by users of financial statements. These questions are the following:

- How much cash was generated by the institution’s operations?
- How much was spent on new plant and equipment, and where did the institution get the cash to finance these purchases?

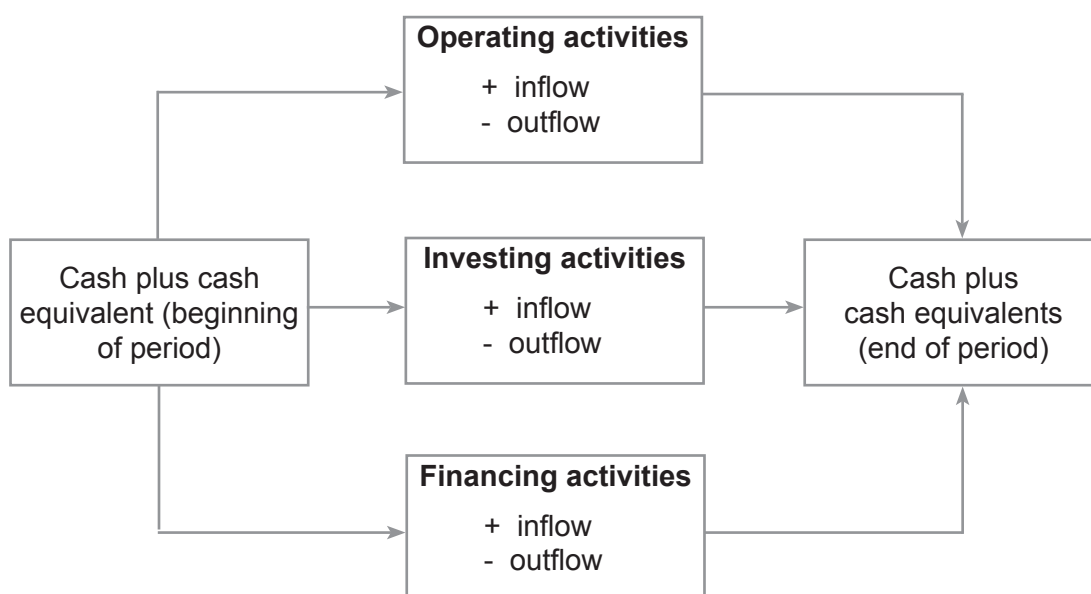
Although accruals accounting procedures are useful in presenting the financial position (balance sheet) and the financial results (income statement) of operations, users of financial statements are also interested in the flow of **cash** in and out of the institution because it is the lifeblood of any institution.

Without cash, employees and suppliers are not paid, and loans are not repaid. In other words, a public institution must have an adequate amount of cash to operate. For these reasons, decisionmakers pay close attention to an institution’s cash position and the events and transactions that cause this position to change. Economic decisions taken by the users of financial statements therefore require an evaluation of the ability of an institution to generate cash and cash equivalents.

Accordingly, the objective of a cash flow statement is to provide users of financial statements with information concerning the source and application of all financial resources during the period, in particular details of cash generated or utilised

by operations, investing activities and financing activities. Cash can be defined as cash in the bank and on hand as well as cash equivalents such as money market investments.

If the relationship of the cash flow statements to the other primary financial statements is considered, it is obvious that the cash flow statement includes information that is not included in the other financial statements. It provides information about the investing and financing activities of the institution as well as the operating activities during the reporting period that is not apparent in the other financial statements (Faul et al 1994:494). Cash receipts and payments are therefore classified as operating, investing and financing activities. These categories of information in the cash flow statement are depicted in the following figure:



**Figure 7.1: Categories of information in the cash flow statement**

Within each category, individual cash receipts and payments are summarised and described in a manner that clearly presents the general nature of the institution's cash transactions (Faul et al 1994:495). The cash receipts and payments in each category are therefore netted against each other. A category provides a **net cash inflow** if the receipts in the category exceed the payments. However, if the payments in a category exceed the receipts, the category is a **net user of cash** during the period. Each of the categories is outlined below:

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**(a) Operating activities**

Operating activities include all the transactions and other events that are not investing or financing activities. Cash flow from operating activities is generally the cash effects of transactions and other events that are taken into account in the determination of the net income (see income statements). Cash received that relates to the sale of goods or services to customers, namely debtors and bills receivable, is classified as operating activities. However, the collection of interest on loans is reported as an operating activity because it appears in the income statement.

**(b) Investing activities**

Investing activities generally include transactions involving the acquisition or disposal of fixed assets and investments, including advances (loans) that are not described as cash. **Cash inflow** from investing activities includes cash received from the sale of property, plant and equipment and cash received from the collection of loans made to others. On the other hand, **cash outflow** from investing activities includes cash paid to purchase property, plant and equipment and cash paid to make loans available to others. If an institution loans money to other parties, the cash receipts from collecting the loans are classified as investing activities. Nevertheless, the collection of interest on such loans is not an investing activity because it appears in the income statement.

**(c) Financing activities**

Financing activities generally include the cash effects (inflow and outflow) of transactions and other events involving long-term creditors, which are those activities that result in changes in the size and composition of the debt and capital of the reporting entity. **Cash inflows** from financing activities include cash received from other short or long-term borrowing. **Cash outflows** for financing activities include repayments of amounts borrowed from other parties. Payments of interest are not regarded as financing activities because they appear in the income statement and are therefore included in operating activities.

The cash flow statement can be prepared by using either the direct method or the indirect method (Melville 1997:275). The **direct method** involves an analysis of the institution's underlying accounting records for the period in question by determining the amount of cash received from customers as well as the amount of cash paid to suppliers and employees and paid for other expenses. These figures are listed at the beginning of the cash flow statement and are then aggregated to give the net cash flow from operating activities. The **indirect method** takes as its point of departure the

institution's operating surplus for the accounting period and then makes a number of adjustments to it to calculate the net cash flow from the operating activities. Although the direct method is undoubtedly the more obvious approach, it has not proved to be popular in practice. This is probably because a reconciliation between the operating surplus and net cash flow from operating activities is required. It therefore makes sense to adopt the indirect method and in so doing satisfy two requirements simultaneously.

Although the line manager in the public sector should be closely involved in the compilation of the financial statements, especially at senior management level, it is necessary that he/she have competent and professional state accountants who can be responsible for compiling the financial statements. This does not take anything away from the fact that line managers should have a good working knowledge of accounting and the accounting process. If they did not, they would not be able to contribute significantly to the compilation of the financial statements. Line managers in the public sector should also understand that the information contained in the financial statements does reflect their ability or inability to manage the finances of their entities properly.

### 3.4 Users of financial statements

The financial statements of a public institution describe the financial results for a specific period and its financial position at the end of the period. However, the financial achievement of the public institution is not evaluated in these statements. The responsibility for analysing, interpreting and evaluating the information contained in the statements for a specific purpose rests with the users of the financial statements. The users of the information contained in financial statements can be divided into two groups of people, namely external users and internal users. **External users** include all persons and organisations that, although they may have a financial interest, exist outside a public institution and are not directly involved in its management. **Internal users**, on the other hand, are generally employed by the enterprise and responsible for its management.

The following main external users with a financial interest in a public institution can be identified:

- legislature and the citizens
- investors and creditors
- other governments and international agencies
- economic and financial analysts
- South African Reserve Bank
- National Treasury and the provincial treasuries
- Statistics SA

In contrast, the internal users of financial and accounting information are the public institution's own personnel, whose task it is to manage the institution in such a way as to achieve the objectives set in its strategic and business plans. This group of personnel is known as management and is accountable to the executive authority responsible for the public institution. The financial statements are the most important sources of information on which public managers can base the decisions that they are taking at the different levels within the enterprise. For planning purposes, this information indicates what the concern is capable of achieving and can expect in the future. As far as control is concerned, the information in the financial statements reflects actual achievement that can be compared with the planned or expected achievement to provide a basis for corrective action.

### 3.5 Analysis and interpretation of financial statements

Before considering the analysis and interpretation of financial statements, it is necessary to distinguish between the two concepts of analysis and interpretation (Faul et al 1994:524):

- The **analysis of financial statements** involves additional investigation and processing of the information contained in the statements, in order to obtain the specific information required by a specific decision-maker for a specific purpose. Periodically public managers would like to assess the effectiveness of their unit and therefore require more information than is merely reflected in the financial statements. By further investigation and processing of the information in the financial statements, they can try to establish trends and patterns in revenue and expenditure.
- The **interpretation of financial statements**, on the other hand, entails determining the causes and implications of situations revealed by the information contained in the statements. Decisionmakers must be aware of which factors can influence a specific situation and of the possible consequences before they are equipped to decide on further action.

Before the information in the financial statements can be used meaningfully it must be analysed and interpreted properly. Two factors are important in the process of analysis and interpretation of financial statements:

- The **interdependence** of the institution's different activities: All the activities of a public institution are related to a greater or lesser degree, which is apparent from the subdivision and co-ordination of functions within an institution. It is therefore necessary that financial statements be interpreted within the framework of the relationship between the different activities of the institution.

- The **trends** that develop over time: The results of an institution's activities seldom remain static but rather are subject to constant fluctuation. The financial information pertaining to a single period cannot reflect these fluctuations. The meaningful analysis and interpretation of an institution's financial performance requires the identification of trends rather than a single value. At the same time, the information contained in financial statements cannot be analysed or interpreted meaningfully unless a clear understanding of both the usefulness and the reliability of the information is obtained.

### **3.5.1 Importance of evaluation criteria**

To determine whether the financial performance of a public institution is satisfactory, it must be compared with a standard (Faul et al 1994:525). There are basically four types of criteria that can be used in such comparisons:

- An objective, predetermined standard or budget
- Historical data particular to the institution, such as comparable figures for preceding periods or related figures
- Data from outside the institution, such as comparative data for other similar institutions
- Empirically accepted standards, including the experience and background of the analyst

### **3.5.2 Ratio analysis**

There are several ways in which financial statements can be analysed (Melville 1997:321). In practice, one of the most important methods is the technique known as ratio analysis, which involves the calculation of a number of accounting ratios. Ratio analysis entails the identification, measurement and evaluation of financial relationships or ratios of the financial position and result (Faul et al 1994:526). In general, the problems of comparability are reduced or eliminated if accounting ratios are calculated and compared rather than comparing absolute figures (Melville 1997:322). At the same time it should be emphasised that performing a ratio analysis on a single set of accounts is usually a fairly pointless exercise. Most of the ratios mean very little in absolute terms and become meaningful only when used as a basis for comparison. In general, ratios are used for making the following comparisons:

- **Comparing one year with another:** The financial performance of an institution for a given financial year and its financial position at the end of that year may be assessed by calculating a set of ratios and comparing the results with the equivalent figure for the same institution in previous years. Any perceived trends might be extrapolated into the future and used as a basis for making economic forecasts.

- **Comparing one institution with another:** Similarly, the ratios calculated for a public institution in a given financial year may be compared with those calculated for other institutions in the same year.

When accounting ratios are used as a means of comparison, they are undoubtedly a valuable tool for the analysis of financial statements. However, ratio analysis does suffer from a number of limitations, and the user should be aware of these before taking decisions on the results of such an analysis. Some of the more important limitations of ratio analysis are the following (Melville 1997:332–333):

- **Lack of standard definitions:** Some accounting ratios may be defined in more than one way. This makes it difficult to compare ratios calculated by different accountants, since each of them might have used different definitions for the same ratios. It is therefore very important that users be aware of this problem when they take important financial decisions based on information provided in the form of a ratio analysis.
- **Unrepresentative balance sheet figures:** A balance sheet shows only a snapshot of an institution's financial position on a single date, whereas an income statement covers an entire financial year. If the institution's assets and liabilities on the balance sheet date are not typical of the year as a whole, any ratio that combines a balance sheet figure with a figure drawn from the income statement might produce a misleading result. Usually the solution to this problem is to use the average of the figures shown in the opening and closing balance sheets. This will, however, be of little help if the institution's balance sheet is annually affected by recurring seasonal factors.
- **Accounting policies:** An institution's accounting policies with regard to matters such as depreciation and the valuation of stock might be very different from those of another institution. These differences in policy may have a significant impact on accounting ratios and can make it difficult to effect a meaningful comparison between the institutions concerned.
- **Misinterpretation:** Accounting ratios are open to misinterpretation unless all available information is taken into account. It is therefore essential that ratios be judged collectively rather than singly, that a given institution's ratios be compared with those of other institutions in the same field, and that anyone performing a ratio analysis be aware of background factors such as the overall economic climate, the rate of inflation and trends in interest rates.

The ratios used for analysing financial statements can be classified as the rate of return ratios, liquidity ratios, solvency ratios, efficiency ratios and investment ratios. The use and application of some of these ratios can be explained as follows:



- **Rate of returns ratio:** This is used to assess whether the institution has succeeded in making an acceptable level of surplus.
- **Liquidity ratio:** This is a measure of the ability of the public institution to pay its debts as they fall due.
- **Efficiency ratio:** This ratio, which is sometimes referred to as the activity ratio, provides some indication of the extent to which the assets of a public institution have been managed efficiently.
- **Investment ratio:** This ratio is mainly of interest to investors or potential investors and may help them to decide whether or not an institution represents a worthwhile investment. However, some investment ratios may be of interest to other user groups.

The financial ratios and other measures to analyse financial statements are summarised in the following table (Meigs et al 1998:277):

**Table 7.1: Summary of analytical measurements**

Ratio or other measurement	Method of computation	Significance
<b>Liquidity measures:</b>		
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	A measure of short-term, debt-paying ability
Quick ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	A measure of short-term, debt-paying ability
Working capital	Current assets minus current liabilities	A measure of short-term, debt-paying ability
Net cash provided by operating activities	Appears in the statement of cash flows	Indicates the cash generated by operations after allowing for cash payment of expenses and operating liabilities
<b>Measure of long-term credit risk:</b>		
Debt ratio	$\frac{\text{Total liabilities}}{\text{Total assets}}$	A measure of creditors' long-term risk
<b>Efficiency or activity measures:</b>		
Return on assets	$\frac{\text{Operating income}}{\text{Average total assets}}$	A measure of the productivity of assets, regardless of how the assets are financed



### 3.6 Limitations of financial statements

Financial statements are subject to a number of limitations and can therefore not provide all the information that users might require (Melville 1997:6–7).

The following limitations can be identified:

- **The limitations of quantitative information:** Information contained in the financial statements is limited to information that can be expressed in quantitative terms. Matters such as the skill of the management team and morale of the workforce are not included at all. Yet these matters could be of great concern to certain decision-makers.
- **Relevance to the past versus the future:** Financial statements are largely confined to an analysis of past events, whereas many users are much more interested in what is likely to happen in the future. Financial forecasts might occasionally be supplied to banks or other lenders in support of a loan application, although public institutions are usually reluctant to make forecast information more widely available. This is because of the reliability of such information. The historical information provided in the financial statements might be used as a guide to the future performance of the institution, but in a dynamic environment there can be no guarantee that such projections will prove to be accurate.
- **Degree of reliability:** Another limitation is that accounting is not an exact science. The preparation of financial statements nearly always involves the exercise of judgement, and this is bound to make the statements less reliable than users would wish. For example, it may be necessary to estimate the remaining useful life of a machine owned by an institution, or to judge the likelihood that a customer who owes money to the institution will ever pay it.
- **The changing value of money:** It is also important to remember that most of the information given in financial statements is expressed in monetary terms and that the monetary unit (rand) is constantly changing in value. This introduces a number of problems, especially in times of high inflation.



Despite these limitations, financial statements do serve a useful purpose. They provide a great deal of vital information, and for many users they constitute the only available guide to the financial performance and position of a public institution.

## 4 FINANCIAL AND PERFORMANCE REPORTING

Financial and performance reporting actually forms part of the budget control process and is a generally accepted practical instrument for continuous internal financial control (Gildenhuis 1993:145). To ensure the success of management's supervision function, it is imperative that they be regularly supplied with progress reports on the execution of the budget. A budget is inter alia a work programme for the financial year concerned, and public managers are obliged to report to top management on the progress made in the execution of the various programmes and projects.

For this purpose a significant progress report is required from the relevant public managers. Such a report should not only compare the actual spending against the estimates provided in the approved budget but also compare the physical results against the budget objectives. This would be a complete report that compares the cost standards, time standards, quality standards and public acceptability of the results with objectives and expectations as contained in the budget documents. A report should identify not only the deviations and discrepancies but also the reason for them. In addition, it should include recommendations on what should be done to put the execution of the programme back on track.

For the purpose of this study, reporting will be discussed by focusing on the users of the reports, the general principles and the objectives of reporting, their qualitative characteristics and the presentation of financial statements, as set out in the *Draft White Paper on Financial Management and Expenditure Budget Reform* (South Africa 1996:21–23):

### 4.1 Users of government's financial reporting

The government and individual spending agencies endeavour to satisfy the information needs of at least the following principal users of its financial reporting:

- legislature and the citizens
- investors and creditors
- other governments and international agencies
- economic and financial analysts

### 4.2 General principle of financial reporting

Financial reporting must communicate information that is relevant to the decision-making and accountability needs of its users.

### 4.3 Financial reporting objectives

The following core financial information on government is required:

- **Information on compliance:** This information is necessary to assess whether resources were used in accordance with the legislature's appropriations and mandates.
- **Information on stewardship:** This information is necessary to:
  - assess the safeguarding, uses and maintenance of both financial and physical assets
  - assess the service potential of physical assets with lives extending beyond one year
- **Information on performance:** This information is necessary to:
  - assess how well objectives have been met
  - assess the ability to maintain the quantity, quality and timeliness of services or products supplied, which can include economy, efficiency, effectiveness and appropriate measures
- **Information on the state of finances:** This information is necessary to:
  - assess the sources and types of revenue
  - assess the allocation and use of resources
  - assess the extent to which revenues were sufficient to cover the cost of policies and operations
  - predict the timing and volume of cash flows and future borrowing requirements
  - assess the ability to meet financial obligations in the short and long term
  - assess the overall financial condition
- **Information on the economic impact:** This information is necessary to:
  - assess the economic impact of the nature and scope of government's activities in relation to the overall economy
  - evaluate government's spending options and priorities

### 4.4 Qualitative characteristics of financial reporting

The information contained in the financial report will be considered useful if the information displays the following characteristics:

- it is proven to be reliable (complete, accurate and valid)
- it is materially relevant to the information needs of its users
- it is understandable

- it is provided in timely fashion
- it is consistent over time and comparable with similar entities

#### **4.5 Presentation of financial statements of government as part of financial reporting**

Concerning the presentation of the financial statements of government (which forms part of financial and performance reporting), the identification and boundaries of the financial reporting entity will be discussed.

##### ***4.5.1 Identification of the financial reporting entity***

The identification of the government financial reporting entity is done by the National Treasury in consultation with the Office of the Auditor-General. Changes to the financial reporting entity are announced in the Government Gazette, and the Minister of Finance or provincial MECs for finance will also notify the responsible ministers/MECs. The core of the government financial reporting entity is the National Revenue Fund and the provincial revenue funds, established respectively in terms of sections 213 and 226 of the Constitution of the Republic of South Africa.

##### ***4.5.2 Boundaries of the financial reporting entity***

Included in the reporting entity will be entities and resources that are under the control of government. Control, for this purpose, can be defined as the power to govern the financial and operating policies of another entity to obtain the benefits and assumptions of the risks normally associated with ownership. Power to govern exists where the government:

- owns the majority of the voting shares; or
- has the power to appoint or remove a majority of the governing body; or
- has a right to more than 50% of the net assets on disestablishment; or
- would be expected to assume any residual liabilities other than pursuant to a guarantee; and
- defrays 50% or more of the entity's expenditure directly or indirectly from funds voted by the legislature.

Where government has legal custody of resources without controlling them (for example, moneys held in trust for private individuals) these resources do not form part of the financial reporting entity. Accountability obligations in respect of such resources will be discharged by the preparation of a special purpose report that will be disclosed in the financial reports of government or the spending agencies.

## 5 ACCOUNTABILITY THROUGH REPORTING

The crisis of accountability includes mismanagement, which can be real, imagined, intentional or inadvertent (Sheldon 1996:5). The solution to accountability lies to a certain extent in formal, public reports that include financial statements and performance reports. From these reports interested parties can obtain information such as that on performance, potential for performance, compliance with legislation and regulations as well as the financial results and position of a public institution.

Timely and accurate information provides a stable backdrop against which the public is able to assess management effectiveness. When reporting is adequate and timely and relevant information is achieved, accountability problems will decline and the perceptions of management will correspond to a large extent with actual management performance. Without a requirement for reporting, accountability will not be possible. It is important that these reports be scrutinised and the information contained in them be assessed by auditors and management/ executive authority to ensure that real accountability is achieved.

## 6 CONCLUSION

From the discussions in this unit it should be evident that financial and performance reporting will play an important role in future to ensure accountability by public managers and executive authorities. Public managers must therefore understand the issues and aspects involved in financial and performance reporting. At the same time they will have to be more knowledgeable about the compilation and the analysis and interpretation of financial statements, which forms a large part of financial reporting, indicating the financial results and financial position (solvency) of a public institution.

Since public managers will be held accountable for the performance and sound financial management of their entities, they will have to become more involved in the financial management and accounting process in their institutions. In addition, they have to build strong relationships with the experts in accounting and financial management in their institutions to ensure that line managers and financial officials cooperate as a team in the overall management of public finance.



## 7 SELF-ASSESSMENT

1. Explain the statutory requirements for financial and performance reporting. (10)
2. Explain the statutory requirements for financial statements. (25)
3. Explain the basis on which financial statements are consolidated in the public sector. (15)
4. Describe the compilation of financial statements. (15)
5. Explain who the users of the financial statements of public institutions are. (7)
6. Explain and describe how financial statements can be analysed and interpreted. (15)
7. Explain the limitations of financial statements. (10)
8. Describe financial and performance reporting in the public sector. (20)
9. Explain how accountability can be achieved through reporting. (5)

## 8 FEEDBACK ON SELF-ASSESSMENT

1. You should have explained the statutory requirements for financial and performance reporting by applying the knowledge that you acquired in section 2 of this unit.
2. You should have explained the statutory requirements for financial statements by applying the knowledge that you acquired in subsection 3.1 of this unit.
3. You should have explained the basis on which financial statements are consolidated in the public sector by applying the knowledge that you acquired in subsection 3.2 of this unit.
4. You should have described the compilation of financial statements by applying the knowledge that you acquired in subsection 3.3 of this unit.
5. You should have explained who the users of the financial statements of public institutions are by applying the knowledge that you acquired in subsection 3.4 of this unit.
6. You should have explained and described how financial statements can be analysed and interpreted by applying the knowledge that you acquired in subsection 3.5 of this unit.
7. You should have explained the limitations of financial statements by applying the knowledge that you acquired in subsection 3.6 of this unit.
8. You should have described financial and performance reporting in the public sector by applying the knowledge that you acquired in section 4 of this unit.
9. You should have explained how accountability can be achieved through reporting by applying the knowledge that you acquired in section 5 of this unit.

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## ANNEXURE: REPORTING RESPONSIBILITIES OF THE EXECUTIVE AUTHORITY AND ACCOUNTING OFFICERS

Type of report	Activity/Requirement	Time frame	Reference
1.1	<b>Executive authority</b>		
Monthly reports	1.1.1 Must consider the monthly reports submitted regarding the undercollection of revenue, shortfall in budgeted revenue and overspending of the vote or a main division (section 39(2)(b)), as well as the actual financial information for a month and a projection of the expected expenditure and revenue for the remainder of the financial year (section 40(1)(c)).	Monthly	Section 63(1)(b)
Annual reports	1.1.2 Table in the National Assembly or provincial legislature the annual report, financial statements and audit report (section 40(1)(d)).	Within a month after the accounting officer has received the audit report	Section 65(1)(a)
Written explanation	1.1.3 Table a written explanation in the National Assembly or provincial legislature for failure to submit the information within six months after the end of the financial year.	Within six months of the end of the financial year	Section 65(2)
Disciplinary board	1.1.4 Table in the National Assembly or provincial legislature the findings of a disciplinary board that has heard a case of misconduct against an accounting officer in terms of section 81.	No specific time stipulated	Section 65(1)(b)
Payments under guarantee	1.1.5 Report, at least annually, to the National Assembly the circumstances relating to payments under a guarantee, indemnity or security issued.	At least annually	Section 70(4)
/continued ...			

Type of report	Activity/Requirement	Time frame	Reference
<b>1.2</b>	<b>Accounting officer</b>		
Unauthorised and other expenditure	Report, in writing, particulars of any unauthorised, irregular, fruitless and wasteful expenditure to the relevant treasury. Irregular expenditure involving procurement of goods and services must also be reported to the relevant tender board.	On discovery	Section 38(1)(g)
Undercollection or overexpenditure	Report to the executive authority and the relevant treasury any impending: <ul style="list-style-type: none"> <li>(a) undercollection of revenue</li> <li>(b) shortfalls in budgeted revenue</li> <li>(c) overspending of the vote or a main division</li> </ul>	No specific time stipulated	Section 39(2)(b)
Financial statements	Submit financial statements of the department to the Auditor-General and the relevant treasury.	Within two months of the end of the financial year	Section 40(1)(c)
Annual reports	Submit to the relevant treasury and executive authority: <ul style="list-style-type: none"> <li>(a) an annual report</li> <li>(b) the audited financial statements</li> <li>(c) the report by the Auditor-General</li> </ul>	Within five months of the end of the financial year	Section 40(1)(d)
Breakdown per month	Provide the relevant treasury with a monthly disaggregation of the anticipated revenue and expenditure for the financial year.	Before the beginning of the financial year	Section 40(4)(a)
Actual and anticipated figures	Submit information to the relevant treasury on actual revenue and expenditure for the month.	Within 15 days of the end of each month	Section 40(4)(b)
Projected figures	Submit to the relevant treasury and the executive authority: <ul style="list-style-type: none"> <li>(a) a projection of expected expenditure and revenue for the remainder of the financial year</li> <li>(b) an explanation of variances and steps taken to remain within the budget</li> </ul>	Within 15 days of the end of each month	Section 40(4)(c)
/continued ...			

Type of report	Activity/Requirement	Time frame	Reference
Inability to comply	1.2.8 Report to the relevant treasury and executive authority the inability to comply with any of the responsibilities in section 40 of the PFMA and the reason for this.	Promptly	Section 40(5)
Other information	1.2.9 Supply to Parliament the relevant legislature, the relevant treasury, an executive authority and the Auditor-General such information, returns, documents, explanations, reports, notices and motivations as may be prescribed or required.	As regulated or required	Section 40(1)(f) and 41
Inventory	1.2.10 When assets and liabilities are transferred, the accounting officer of the transferring department must file a copy of the signed inventory with the relevant treasury and the Auditor-General.	Within 14 days of the transfer	Section 42(3)
Utilisation of savings	1.2.11 Submit to the executive authority details of the utilisation of a saving under a main division towards the defrayment of excess expenditure under another main division.	Within seven days	Section 42(3)
Directive that will lead to unauthorised expenditure	1.2.12 File a copy of a directive by the executive authority that will result in unauthorised expenditure with the National Treasury and the Auditor-General and, in the case of a province, also with the provincial treasury.	Promptly	Section 64(3)

