

**A PERFORMANCE MEASUREMENT APPROACH TO
IMPROVE FINANCIAL MANAGEMENT IN PROVINCIAL
GOVERNMENTS IN SOUTH AFRICA**

HENDRIK ANDREAS VAN WYK

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BY

HENDRIK ANDREAS VAN WYK

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TERMINOLOGY

Accrual accounting: A basis of accounting in which revenues are recognised in the period earned, and expenses are recognised in the period incurred (Vorster et al. (2002:15).

Activity-based budgeting: A budgeting framework based on estimating costs of products and services using activities as a base (compare Drury 2001:301).

Activity-based costing (ABC): A method of attributing costs to products based on first assigning costs of resources to activities and then costs of activities to products (Albrecht et al. 2002:mb-2).

Budgetary process: A process whereby a budget is compiled from the planning to the budgeting phase (Drury 2001:279).

Budgetary system: A system of suitable administrative procedures introduced to ensure that the budgetary process works effectively (Drury 2001:286).

Balanced scorecard: A new management model designed to link together performance measures for financial, customer, internal processes and learning/growth perspectives that are unique to a strategy of an organisation (Albrecht et al. 2002:mb-1).

Capital expenditure: Current outlays on long-term assets in return for a stream of benefits in future years (Drury 2001:243).

Cash accounting: A basis of accounting in which revenue is recognised in the period cash is received, and expenses are recognised in the period paid (IFAC 2001:5).

Funding: The funding from an upper level/sphere of government authority (compare National Treasury 2001:3).

Governing Bodies: The executive committee of a province consisting of political leaders or from a department perspective the management committee to control and monitor management (IFAC 2001:par. 70).

Government: Three spheres of government including, central, provincial and local governments (IFAC 2000:200).

Key performance indicators (KPIs): Important qualitative and quantitative measures of output that provide a guide for performance (MAB 1997:118).

Line-manager: A government official including the Accounting Officer, Chief Financial Officer or any other official with managerial responsibilities (compare MAB 1997:1).

Medium-Term Expenditure Framework: A framework of three-year budgeting that incorporates long-term strategies (National Treasury 2001:15).

Outcomes: The influence of government activities on the community (MAB 1997:119).

Outputs: Products and services produced by departments (IFAC 2000:200).

Organisation: A government department, constitutional institution or public entity (National Treasury 2001:3).

Service delivery improvement programme: A White Paper to provide a policy framework and practical implication strategy for transformation of public service delivery (Department of Public Service Administration 1997:1).

Working capital management: Entails the management of current assets and current liabilities that are to be realised in the short-term (Ross et al. 1990:702).

Zero-based Budgeting: A concept of budgeting that requires all levels of management to start from zero and estimate budget data as if there had been no previous activities in their unit (Warren et al. 2002:178).

LIST OF ABBREVIATIONS

ABB	Activity-based Budgeting
ABC	Activity-based Costing
CEO	Chief Executive Officer
CFO	Chief Financial Officer
GRAP	Generally Recognised Accounting Practice
IASC	International Accounting Standards
IFAC	International Federation of Accountants
IPSAS	International Public Sector Accounting Standards
MAB	Management Advisory Board of Australia
MEC	Member of the Executive Committee
MTEF	Medium-Term Expenditure Framework
PFMA	Public Finance Management Act
PSC	Public Sector Committee
SAICA	South African Institute of Chartered Accountants
UK	United Kingdom
USA	United States of America

SUMMARY

The financial management in the public sector can be improved by the development of an integral accrual accounting system to enable the preparation of accrual-based budgets, financial statements and performance reports to meet the needs of the various stakeholders.

Traditionally the management of government expenditures has been focused on a system of expenditure control, which is based on the cash basis of accounting, to ensure that budgetary authority granted by the legislature is not exceeded. The cash basis of accounting does not measure the resources consumed during the period under review, thus the true costs of government programmes and projects are not correctly measured, controlled or reported.

In the absence of accurate cost information, performance measures of efficiency and cost-effectiveness cannot readily be determined. The Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) is currently involved with the establishment of International Public Sector Accounting Standards. These standards will introduce the accrual basis of accounting and is a significant step towards transparent and accountable information.

The financial successful and efficient organisations are headed by competent management and make use of effective budgetary control. Effective budgetary control is based on operating budgets that are closely linked with long-term strategic plans and desired outcomes. The operating budgets are then compared with actual results, on an accruals basis, in order to measure performance and efficiency. It is clear from the above that three prerequisites exist for performance measurement, namely (i) committed and competent line-managers; (ii) outcomes-based budgeting; and (iii) accruals-based reporting. The balanced scorecard is a useful tool to document the strategies and the performance measures of outputs.

A performance measurement framework that uses the balanced scorecard as a base are developed for provincial governments and incorporates (i) the implementation of an outcomes-based budget; (ii) the use of an accruals-based cost/revenue allocation to measure the costs of the various outputs; and (iii) a performance statement.

Committed and competent line-managers are the first prerequisite for performance measurement. The responsibilities and training needs of the Executive Authority, Chief Executive Officer (CEO) and Chief Financial Officer (CFO) are clearly defined and the training needs of provincial government officials are highlighted.

Outcomes-based budgeting is the second prerequisite for performance measurement. The public sector managers in provincial governments should take cognisance of the shortcomings of the current budgeting process and consider the implementation of activity-based budgeting.

Reporting on an accruals basis is the third prerequisite for performance reporting. Internal reporting in provincial government departments should be revitalised and activity-based costing should be implemented to facilitate accruals-based cost allocations to all the various activities and processes that are required for each output.

Finally, the study recommends a performance statement that can be incorporated into the financial statements of provincial government departments, which will be in total harmony with the income statement and the balanced scorecard.

KEY WORDS

Accrual accounting; activity-based budgeting; activity-based costing; balanced scorecard; financial management; performance measurement; performance reporting.

OPSOMMING

Die finansiële bestuur in die openbare sektor kan verbeter deur die implementering van 'n geïntegreerde rekeningkundige stelsel om begrotings, finansiële jaarstate, en prestasieverslae op 'n toevallingsbasis op te stel en sodoende die behoeftes van die belanghebbendes te bevredig.

Die bestuur van regeeringsuitgawes was tradisioneel gefokus op 'n stelsel van uitgawebeheer, wat gebaseer was op kontantbasis-rekeningkunde. Die beheer het ten doel gehad om te verseker dat bedrae wat deur regeeringsowerhede voorgeskiet is, nie oorskry word nie. Kontantbasis-rekeningkunde meet nie uitgawes wat gedurende die periode aangegaan is of ontstaan het nie en derhalwe word die koste van projekte van die regering nie akkuraat gemeet, beheer en oor verslag gedoen nie.

In die afwesigheid van akkurate koste-inligting kan die prestasie-meting en koste-effektiwiteit nie bepaal word nie. Die Openbare Sektor Komitee van die Internasionale Federasie van Rekenmeesters is tans besig om internasionale rekeningkundige standaarde op te stel. Hierdie standaarde sal toevallingsrekeningkunde aanbeveel wat 'n wesenlike stap na deursigtige en verantwoordbare inligting is.

Finansieel gesonde instellings word gelei deur bekwame bestuur en maak gebruik van effektiewe begrotingsbeheer. Effektiewe begrotingsbeheer is nou gekoppel aan langtermyn strategiese doelwitte en verlangde uitkomst. Die bedryfsbegrotings word dan met die werklike resultate wat volgens die toevallingsgrondslag voorberei is, vergelyk om prestasie en effektiwiteit te meet. Dit is duidelik uit die bogenoemde dat daar drie voorvereistes vir prestasie-meting bestaan, te wete (i) Lojale en bekwame lynbestuurders; (ii) uitkomsgebaseerde begrotings; en (iii) toevallingsgebaseerde verslagdoening. Die gebalanseerde telkaart is 'n bruikbare instrument om strategiese doelwitte en prestasiemaatstawwe te dokumenteer.

'n Prestasiemetingsraamwerk wat die gebalanseerde telkaart as basis gebruik, word vir provinsiale regerings ontwikkel wat die volgende inkorporeer; (i) die implementering van 'n uitkomsgebaseerde begroting; (ii) 'n kosteberekeningstelsel om koste van uitsette te meet en wat op 'n toevallingsbasis gegrond is; en (iii) 'n staat van prestasie.

Lojale en bekwame lynbestuurders is die eerste voorvereiste vir prestasiemeting. Die verantwoordelikhede van die uitvoerende liggaam, hoof uitvoerende beampte en hoof finansiële amptenaar van provinsiale departemente word duidelik gedefinieer. Die opleidingsbehoefte van regeringsamptenary word ook aangespreek.

Uitkoms-gebaseerde begrotings is die tweede voorvereiste van prestasiemeting. Die bestuur in provinsiale departemente moet ag slaan op die huidige tekortkominge in die begrotingstelsels en moet die implementering van aktiwiteitsbasisbegrotings oorweeg.

Verslagdoening op 'n toevallingsgrondslag is die derde voorvereiste vir prestasiemeting. Interne verslagdoening in provinsiale regeringsdepartemente moet herontwikkel word. Die koste van aktiwiteite en programme moet op 'n aktiwiteitsbasis en toevallingsgrondslag bereken word en na elke uitset geallokeer word.

Laastens word aanbeveel dat 'n staat van prestasie in die finansiële jaarstate van provinsiale departemente geïnkorporeer word en wat in harmonie met die inkomstestaat en die gebalanseerde telkaart behoort te wees.

TREFWOORDE

Toevallingsrekeningkunde; aktiwiteitsgebaseerde begrotings; aktiwiteitsgebaseerde kosteberekening; gebalanseerde telkaart; finansiële bestuur; prestasiemeting; prestasieverslagdoening.

A PERFORMANCE MEASUREMENT APPROACH TO IMPROVE FINANCIAL MANAGEMENT IN PROVINCIAL GOVERNMENTS IN SOUTH AFRICA

CHAPTER 1

INTRODUCTION

1.1 OPENING REMARKS

The performance measurement approach highlights the importance of the setting of benchmarks or predetermined measures to assess accountability in the public sector. These benchmarks and measures are predetermined by using the strategies and desired outcomes of an organisation as a base that incorporates the planning and budgeting process. Nevertheless, performance measurement can only be completed if actual results are reported and compared with the predetermined benchmarks or measures. Reporting is the final activity to conclude the performance measurement process. From the aforementioned it follows that performance measurement and reporting are closely related.

1.2 BACKGROUND TO THE STUDY

Globally a growing trend has emerged towards public sector reform. The international focus on the improvement of service delivery necessitated a closer look at results (outputs and outcomes) and performance of public sector departments and agencies. Du Randt (1999:9) regards this as a fundamental shift in the way public sector departments are managed around the world.

In South Africa the management of government expenditure has traditionally been focused on a system of expenditure control to ensure that budgetary authority granted by the legislature is not exceeded. In striving to achieve “appropriation control”, the Government traditionally apply the “cash” basis of accounting whereby expenditures were measured by the payments that were made by public sector entities during the fiscal year (Generally Recognised Accounting Practice (GRAP) Project Team 1998:4). The focus was on the “inputs” or the cost side only, with the main emphasis on the borrowing requirement. The cash basis of accounting, however, does not measure the resources consumed during the period under review, thus the true costs of government programmes and projects are not correctly measured, controlled or reported. Alexander (1999: 52) explained the difference between accrual and cash accounting by indicating that under accrual accounting income is recognised when it occurs and not when it is received. Expenses are recognised when goods or services are received and not when the bills are paid at a later stage. In contrast, under cash accounting income is recorded when money is received and expenses incurred when bills are paid.

Keelan (2001:34) is of the opinion that accrual accounting will help departments to focus on outputs and the achievements of objectives and will also enable measurement of the full costs of outputs. This is not possible under the existing cash accounting systems.

In the absence of accurate cost information, performance measures of efficiency and cost-effectiveness cannot readily be determined other than by performing relatively expensive ad hoc studies. The financial information currently available cannot appropriately satisfy the need to evaluate or control the operations and projects under review. Section 8 (1) (a) of the Public Finance Management Act, 1999 (Act 1 of 1999) (as amended by Act 29 of 1999) (PFMA) requires the National Treasury to prepare financial statements in accordance with Generally Recognised Accounting Practice (GRAP) in respect of public sector entities. Section 87 of this Act further provides for the establishment of an Accounting

Standards Board (ASB) to set the statements of generally recognised accounting practice. These standards will introduce the accrual basis of accounting in the South African public sector, and will be based on the best international standards available (Brown 1999:21). This is a significant step in the reform process in government financial reporting, with the result that monitoring performance against objectives will be easier. It is against this background that the current study is undertaken.

1.3 SELECTION OF TOPIC

The objective of a financial management system in the public sector should be to support management in their deployment of limited resources with the purpose of ensuring economy and efficiency in the delivery outputs (that is, services and/or goods produced by entities in terms of quantity, quality, cost and time), which are required to achieve desired outcomes (effectiveness) that will serve the needs of the community (International Federation of Accountants 2001: par. 282). To improve performance, performance also needs to be measured and reported in other terms than monetary terms (Management Advisory Board 1997:50). Without information about what is being achieved (outputs) and its cost (inputs), it is impossible to make efficient resource allocations within the public sector, and to measure actual performance against the resource allocations.

The Australian public sector in 1998 transformed to an accruals-based management framework. Accrual accounting is an important component of accruals-based management. According to the Management Advisory Board (1997:2) the framework will have an explicit focus on outputs and outcomes and thus complement the shift to a performance culture.

Performance measurement and reporting per se are useful management and accountability tools. Both internal and external users need the performance information. Internal users need information on the performance of the entity in terms of effectiveness and efficiency to make improvements. Public sector entities may require performance information to decide how much to spend and where

within the sector they should be allocated. In particular these entities will be interested to know what results may be achieved as a consequence of a particular level of funding, or to decide whether or not a service could be delivered more efficiently and effectively by the private sector through outsourcing.

Public sector entities will be held accountable not only for the money entrusted to them, but also for the results. External users will thus also need information on performance to assess whether the entity has effectively used available resources and whether it is deserving of further investment.

The question whether a performance report or statement should be part of the annual financial statements for the purpose of the external users can also be posed. As 96% (26 of 27) of the respondents in the questionnaire indicated, the answer is positive. Financial statements in the private sector include various informal statements such as segment reports, value-added statements, employee reports and green reports (Wells et al. 2002:6). These statements and reports are not directly required by law but are presented for the sake of fair presentation. Section 1 of the PFMA of 1999 deals, among others, with the definition of financial statements. This definition includes "any other statements that may be prescribed" and therefore the financial statements may include a performance report. This study will propose a formal performance statement that can be included in the annual financial statements of a public entity.

Generally recognised accounting practice will require the introduction of a new classification system. It is appropriate, therefore, to initiate a study on performance reporting in the early stages of implementing accrual accounting in the public sector, as it would impose certain additional requirements on the system of classification of transactions.

1.4 PROBLEM STATEMENT

Shortcomings in management measures involving millions of Rands where the taxpayer did not receive value for money, are regularly reported to Parliament in audit reports tabled by the Auditor-General. Mr Shauket Fakie, Auditor-General (1999:13) is of the opinion that the lack of priority afforded to financial management in the public sector has remained a serious concern. Fakie (1999:14) listed, among others, the following shortcomings that were identified during audits performed by the Auditor-General:

- Long-term planning, linked to resources, frequently does not take place in a formal manner. The coordination of planning actions is not always satisfactory;
- the lack of measurable objectives, performance criteria, norms, standards and other indicators make effective measurement and benchmarking virtually impossible;
- there is generally no regular evaluation of the efficiency and effectiveness of rendering a service; and
- management information systems do not always provide the necessary information and often function in an uncoordinated manner.

Although various initiatives and new approaches to financial management are underway, some deeply rooted shortcomings remain largely unresolved (Visser 2000:294). The empirical study revealed the following shortcomings: Poor financial management practices; lack of skills and expertise employed in the public sector; attitude of staff in the transformation process from financial administration to financial management; as well as the outdated financial management information systems that are based on a cash basis of accounting.

Traditionally the focus was on keeping within the budget, but this focus shifted towards a greater understanding of the relevant costs associated with the output achieved. This can only be achieved by moving away from the cash basis of

accounting to an accrual system of accounting, which will enable the determination of the true costs of goods and services rendered (outputs) and will enhance the assessment of the stewardship or accountability of management. According to the GRAP Project Team (1998:13) the implementation of accruals-based accounting and management information will be a demanding challenge. Interviews were conducted with various private sector Chartered Accountants who have audit engagements in the public sector, staff of the Auditor-General and line-managers of the Free State Provincial Government. From these interviews it is apparent that among others, three major obstacles exist to overcome the implementation process of accruals-based information. These are (i) the need for skilled human resources; (ii) the implementation of new management information systems; and (iii) the challenge to get the fixed assets that was expensed under the cash system back on the books.

Du Randt (1999:10) is of the opinion that this change means that departments will need knowledgeable financial people to manage outputs rather than inputs. The Management Advisory Board of Australia (1997:4) concluded that the traditional role of financial operatives in both public and private sectors are being challenged. The demand for value-adding financial analysis skills replaces the need for arithmetic-skills for number crunching and transaction processing. In part, this was driven by better technology, but more significantly by the realisation that accountants will be required to provide decision-making support, not just accounting data, for organisations to be effective. To change mindsets and cultures of financial officials in the public sector who got used to the current cash accounting systems that were in force for approximately 30 years, will be difficult. According to 93% (27 of 29) of the respondents management skills should change dramatically whilst 72% (21 of 29) of the respondents were of the opinion that leadership skills will need redress. Sinnett (2001:20) reported that about 8 000 officials are in 'real' finance posts in national and provincial governments, although up to 40 000 public servants are linked in some way to the financial processes of government. The training needs of these officials must therefore also be considered.

However, financial statements prepared on the accrual basis of accounting are primarily limited to data that are both historical and financial. This information is often not responsive to all the decision-making needs of users who also need non-financial information about performance.

The abovementioned problems can be divided into three categories, namely (i) the need for trained and committed staff; (ii) a budget system that links with strategic outcomes; and (iii) a performance reporting framework on an accruals basis. These three areas form the base of this thesis.

1.5 FORMULATION OF HYPOTHESIS

The financial management in the public sector can be improved through the development of an integral accrual accounting system to enable the preparation of accrual-based budgets, financial statements and performance reports to meet the needs of the various stakeholders. Furthermore, a performance measurement framework that incorporates accruals-based budgets, linked with clearly identified objectives and outcomes, which can be compared to and measured with the actual outputs and with their related accrual costs of the inputs, would enhance the quality of service delivery, which is the prime objective of government in general.

1.6 OBJECTIVES OF THE STUDY

The managers of successful organisations are competent, committed and able to report on the effectiveness of the organisations and on the fact that resources are acquired economically and utilised efficiently and effectively (compare MAB 1997:2). These financial successful organisations make use of effective budgetary control. Effective budgetary control is therefore based on operating budgets that are closely linked with long term strategic plans and outcomes. These operating budgets are then compared with actual results, on an accruals basis, in order to measure performance.

The objective of this study is to identify the main features of effective financial management in the provincial government sphere that can be enforced as a solid foundation for performance measurement. The development of a conceptual accruals-based performance-reporting framework has to be applied by provincial government departments in South Africa. This framework will be used as a base to develop a performance statement that can be incorporated into the financial statements and to ensure that it will be in total harmony with the income statement.

1.7 SCOPE OF THE STUDY

This study will concentrate on financial management and in particular performance reporting in provincial governments with specific reference to the Free State Provincial Government. The principles of financial management are based on practices followed in the private sector.

It should further be noted that although environmental differences do occur in different provincial governments, the applications and the findings of this study can also be applied to other provinces. It can also be applicable to the three spheres of the public sector in South Africa, namely the central government, provincial government and local government spheres.

1.8 METHODOLOGY

A literature study of recent developments of financial management practices will form the basis of this thesis in order to formulate a conceptual accruals-based framework for performance reporting. In July 2001 initial consultations were conducted with senior staff members of the office of the Auditor-General as well as with external auditors who are involved in audit engagements of government departments. A questionnaire was also designed and distributed among Accounting Officers, Chief Financial Officers and senior finance staff of all the departments of the Free State Provincial Government. The questionnaire was also

sent to senior Auditor General Officials and external auditors involved with the Free State Provincial Government. A 100% sample was drawn of the population. According to Schnetler et al. (1989:10) a sample of 10% or more of the population is representative of the target population. Compared with the norm as stated by Schnetler et al. (1989:100) the above sample is regarded as representative.

The feedback was highly successful as 29 of the 42 questionnaires were completed and sent back for processing. This represents a 69% response. The reason for this success rate is the personal collection of questionnaires at the deadline date and the continuous follow-up of outstanding questionnaires. The respondents can be categorised as follows:

Table 1 Questionnaire particulars

Category	Number of responses
Chief executive officers	5
Chief financial officers	8
Senior staff of the Auditor-General	3
External auditors	13
Total	29

From the above it is clear that 13 from the 29 respondents are from the private sector. They are all independent auditors involved with audit engagements in the public sector and have qualified as chartered accountants. One of the CEOs has a doctorate in literature, two of the CEOs have masters degrees and two have bachelors degrees. One CFO has a doctorate in financial management, one of the CFOs has a masters degree and four CFOs bachelor degrees in commerce. The other two CFOs who responded did not indicate any qualification. The three senior

staff members of the office of the Auditor-General all have bachelor degrees in commerce.

The empirical results will be discussed throughout the thesis and will also be highlighted in the conclusions and recommendations. Respondents were asked inter alia to provide effectiveness ratings regarding financial management, budgeting systems and financial reporting in provincial governments that are also summarised in the chapters concerned. Comments of the external auditors, Auditor-General, CEOs and line-managers of the departments will also be documented in the paragraphs to which they relate.

1.9 CONTENTS OF THE STUDY

The contents of the study are in a logical sequence and will consist of the following seven chapters:

Chapter one deals with the need, objectives and scope of the study. It also refers to the background and reason for the selection of this topic, the problem statement and the formulation of hypothesis. The methodology and contents of the study are also outlined.

In chapter two the developments of financial management in the public sector are highlighted including other related developments such as new public management and corporate governance. The current shortcomings of financial management in provincial governments are discussed together with the features for effective financial management to address these shortcomings that have been identified. The features for effective financial management were then analysed and three foundations for effective financial management in the public sector are identified, namely competent line-managers, outcomes-based budgeting and accruals-based reporting.

Chapter three contains performance measurement and its nature. Performance measurement is defined and key performance indicators (measures) are characterised. The important links between strategic planning and performance measurement are highlighted together with the use of the balanced scorecard to facilitate these important links. A performance statement, that is in harmony with the income statement and that can form part of the annual financial statements, is recommended. The three categories of effective financial management are also identified as prerequisites for performance measurement.

In chapter four the first prerequisite of performance measurement, committed and competent line-managers, is discussed. Line-managers in provincial governments are also identified. The responsibilities of the Executive Authority, Chief Executive Officer (CEO) and Chief Financial Officer (CFO) are highlighted as well as the training needs of the provincial government staff.

In chapter five the second prerequisite of performance measurement, outcomes-based budgeting, is dealt with. The difference between planning and budgeting is endorsed. The budgeting methods used in provincial government departments as well as the shortcomings of the current budgetary systems are also identified in this chapter. The differences between zero-based budgets, line-item budgets, programme budgeting and activity-based budgeting are highlighted. The features of effective budgeting systems are addressed and the necessity to integrate the accounting and budgeting systems. The chapter concludes with the necessary steps for effective budgeting by using the activity-based budgeting method that is based on the activity-based costing techniques.

In chapter six the third prerequisite of performance measurement, accruals-based reporting, is discussed. The main features of accrual accounting/reporting are highlighted in this chapter together with the advantages thereof compared to the conventional cash basis. The differences of internal and external reporting are addressed and their current formats in provincial government departments. The different users of financial reporting are identified together with their respective

needs. This chapter also deals with the implementation of accruals-based cost allocations to all the various activities and processes that are required for each output. Finally the PFMA and Treasury requirements of annual and interim reporting are highlighted.

In chapter seven the practical implementation of the performance measurement approach is discussed with inputs of senior auditors of the Office of the Auditor-General of the Free State. A performance statement is also developed that can be included in the financial statements of provincial government departments.

In chapter eight a summary of findings and the recommendations of this study are documented as well as a list of future studies with regard to related topics that may be conducted.

CHAPTER 2

FINANCIAL MANAGEMENT IN THE PUBLIC SECTOR

2.1 INTRODUCTION

Change in managing government entities takes place at breathtaking speed. Governments are currently moving away from public administration towards public management and towards a more businesslike approach in managing their affairs. Developments such as the New Public Management, the adoption of corporate governance in the public sector and the proclamation of the Public Finance Management Act (PFMA) highlight the shift of a business outlook on management processes. During the past few years financial management and accounting in the public sector have been characterised by several developments at international and national level. The most important development was the proposal to introduce accruals-based accounting in the public sector in the near future.

This chapter deals with new public management and recent developments in financial management in the public sector and highlights the principles and features of sound financial management practice. Corporate governance and its relation to financial management in the public sector will also be discussed. The developments internationally and in South Africa are also emphasised. To conclude this chapter it is necessary to prepare a broad guide of the features of sound financial management.

2.2 THE INFLUENCE OF NEW PUBLIC MANAGEMENT ON FINANCIAL MANAGEMENT

Due to environmental changes new developments in the public sector emerged inter alia the introduction of the term New Public Management. The term is controversial and has many names. Pollitt (1993) describes it as managerialism, Lan and

Rosenbloom (1992:535-537) saw it as a rise of a new market-based public administration and Osborne and Gaebler (1993:18) described the term as entrepreneurial government.

The term, therefore, challenges the classical administrative considerations about the structure and function of public services. The Wilsonian dichotomy between politics and administration, the Weberian ideal type bureaucracy and the Taylorian idea of one best way, have been supplanted by the goals of financial efficiency and effective service delivery (Fox & Miller 1995:3). Generally speaking, this trend could be described as a transformation from public bureaucracy to one model of administration that is business like, but is not like a business (Gray 1999:3). New Public Management highlights the adoption of a business outlook and this is manifested by a set of techniques and methods related to performance evaluation and measurement and by a set of values such as productivity, competitiveness and quality. Business logic is dominant and underlines the core values of administrative culture (efficiency, effectiveness and economy) without replacing the traditional values of legality, impartiality and equality (compare Bishop 2000:9).

The demand for new public management, therefore, aims not only to improve administrative output technically, but also to develop public relations techniques based on communication skills, simplified administrative formalities and procedures, cooperation in public affairs, safeguarding the public interest, developing partnership practices, transparency, fighting corruption, promoting a code of ethics, citizen participation in public affairs and consultation. The objective is to turn administration into a tool for development and social change, imbued with a concern for performance and greater consideration for the general interest in order to give priority to the interest of citizens by promoting moral values and civic trends (Kroukamp 2000:270). New Public Management and financial management are therefore in harmony as the improvement of administration techniques and the safeguarding of public interest are common grounds.

It will become clear in the following section that the abovementioned together with the principles of corporate governance will enhance the achievement of the objectives of the new public management.

2.3 CORPORATE GOVERNANCE AND FINANCIAL MANAGEMENT

The International Federation of Accountants (IFAC 2001: par. 1) indicated that in recent years, many developed and developing countries have embarked on a thorough re-evaluation of the role of the government in their societies. South Africa is also no exception. Flowing from this, a redefinition of the political-administrative relationship has evolved, designed to ensure greater accountability and a greater devolution of power to managers.

The new challenges of governing seem increasingly complex, including the fast paced economic and social changes, the growing complexity of policy issues, the need for a simpler and more transparent political process, the multiplication of controls, too many procedures that impede change, low morale of public servants, low public administration productivity, growing financial constraints, and citizens' lack of confidence in the public service (Laegreid 2001:2). Change furthermore takes place rapidly, placing governments and public administrations in situations that are probably quite different from those they knew before. Today, developing countries, such as South Africa, need to find answers geared to today's needs in order to clear up ambiguities concerning some of the basic principles by which it is governed.

Corporate governance is a term used to describe the overall management of an organisation. Over the past decade corporate governance has brought about much debate and change in the private sector. The question is whether corporate governance is also applicable to public sector entities. The IFAC (2001:par. 2) refers to corporate governance as structures and processes for decision-making and accountability, control, and behaviour at the top of organisations. "Corporate" refers

to a body or organisation, and the use of the term “corporate” in “Corporate Governance” can be extended beyond companies and business corporations in the private sector. Corporate governance has therefore a broader application and should also form the base of financial management in the public sector. Fakie (1999:14) supported this view by stating that Corporate Governance deals with controls, decision-making and structures for accountability in an entity that will assist in ensuring that the objectives of sound financial management practices are achieved.

Governance in the public sector has a political dimension because the roles of the stakeholders in governing the public sector are important. The stakeholders will be represented by a governing body, for example the parliament, who has by elected representatives the responsibility for appraising performance. The stakeholders also include providers of resources (taxpayers, lenders, bondholders, creditors), service provider/partners (employees, contractors, and joint venture partners and other government entities), users of services (individuals and businesses who benefit from the services that the entity provides), interest groups, analysts/statistic gatherers (policy analysts, economists, financial analysts, rating agencies), media and the wider community (compare Vorster 2001:14).

The main objective of corporate governance in the public sector is to ensure that the government deliver services in a way that is equitable, efficient, effective and affordable, and consistent with the principles of service delivery such as universal coverage and environmental sustainability. All these aspects are in harmony with the principles of corporate governance and indicate that corporate governance (see below) is just as applicable to the public sector as it is to the private sector. This was confirmed by the empirical study in this thesis. Ninety-seven per cent (97%) of the respondents are of the opinion that corporate governance principles should be enforced in provincial governments as a basis for effective financial management. These principles are openness, integrity and accountability. IFAC (2001: par. 332 – 334) describes these principles as follows:

- **Openness (transparency)** is required to ensure that stakeholders can have confidence in the decision-making processes and actions of public sector entities, in the management of their activities, and in the individuals within them. Being open by means of meaningful consultation with stakeholders and communication of full, accurate and clear information leads to effective and timely action and lends itself to necessary scrutiny. King (2002:12) also referred to openness as the **independence** of information without dominance of a particular viewpoint. Financial management cannot be effective without the transparent disclosure of accurate financial information to all the various stakeholders (compare White Paper on Transforming Public Service Delivery 1997:16-22).
- **Integrity** comprises both straightforward dealing and completeness of disclosure of information. It is based upon **honesty, fairness** and **objectivity**, and high standards of propriety and probity in the stewardship of public funds and management of the affairs of an entity. Integrity is dependent on the effectiveness of the control framework and on the personal standards and professionalism of the individuals within the entity. It is reflected both in the decision-making procedures of the entity and in the quality of its financial and performance reporting. The total commitment of management with regard to honesty and objectivity is one of the principles of financial management. King (2002:11) also referred to commitment as the **discipline** that management should have in fulfilling their duties. The Management Advisory Board (MAB) (1997:42) is of the opinion that the establishment of accountability, responsibility and performance within an entity is the responsibility of the Chief Executive Officer (CEO) and the senior management team.

- **Accountability (responsibility)** is the process whereby public sector entities, and the individuals within them, are responsible for their decisions and actions, including their stewardship of public funds and all aspects of performance and submit themselves to appropriate external scrutiny. It is achieved by all parties having a clear understanding of those responsibilities, and having clearly defined roles in a robust structure. Both internal and external accountability and reporting structures are attributes of sound financial management (compare Gildenhuis 1997:56). King (2002:7) made a distinction between accountability and responsibility by stating that one is liable to render an account when one is accountable and one is liable to be called to account when one is responsible. Accountability, therefore, is enforced by law, policy or statute and responsibility by conduct and a positive relationship with its stakeholders. King (2002:12) also referred to the latter as **Social Responsibility**.

Openness, integrity and accountability discussed as the principles of corporate governance can be regarded as the foundation of financial management and are in line with the objectives set for this thesis as reflected in paragraph 1.6 in chapter 1.

The recognition of the principles of corporate governance should ensure that any potential problems, such as dishonesty, misappropriation of assets or ineffectiveness of management are discovered and brought to light. No system of corporate governance can provide total protection against management failure or fraudulent behaviour. However, risks can be reduced by making all participants in the corporate governance process - members of governing bodies, employees, auditors and the shareholders - aware of what is expected from them (compare Swart 2001:20-21).

Public expectations of corporate behaviour in the public sector are continually rising and the principles of corporate governance, listed above, are offered both as a

practical response to these rising expectations and as a practical step towards improving the effectiveness of corporate governance across the public sector in countries around the world.

Corporate governance is thus a significant development that will affect both the public and the private sectors. Internationally, however, this was not the only development in the public financial management field as will be seen in the subsequent section.

2.4 INTERNATIONAL DEVELOPMENTS IN PUBLIC FINANCIAL MANAGEMENT

Globally a growing trend exists towards public sector reform and government accounting reforms that take place at a rapid pace. Van der Linde (1994:9) as quoted by Visser (2000:294) recommends that the South African government should take into account the developments in countries such as New Zealand, Australia, the Netherlands, United Kingdom (UK), United States of America (USA) and Canada.

Seeking to improve government accountability, the Public Sector Committee (PSC) of the IFAC has undertaken a multi-year initiative to develop a series of recommended public sector accounting standards and related guidance (SAICA 2001:30). Ian Mackintosh, the PSC chairman stated: "The PSC set itself an ambitious task of developing by the end of 2001 a core set of International Public Sector Accounting Standards (IPSAS) based, to the extent appropriate, on the Standards of the International Accounting Standards Committee" (IASC) (SAICA 2001:30). Mackintosh also indicated that the IFAC was planning to develop a guide to assist entities in moving from the cash to the accrual basis of accounting. On 22 August 2001 it was announced in the Internet News Bulletin of IFAC that South Africa would harmonise with these international standards as soon as these standards had been finalised

(Internet News Bulletin:2001). Although this was announced the public sector in South Africa is currently not in a position to accommodate these standards as the accounting systems are still on a cash basis.

The IFAC (2001:par. 94) stated that governing bodies of public sector entities need to oversee and ensure that procedures are in place that would result in effective and efficient budgeting and financial management. Governing bodies of public sector entities needed to establish and report performance measures to ensure and demonstrate that its resources have been procured economically and are utilised efficiently and effectively.

The international focus (and also currently in South Africa) on the improvement of service delivery has necessitated a closer inspection of results (outputs and outcomes) and performance of public sector departments and agencies. This resulted in a fundamental shift in the way public sector departments are managed around the world (Du Randt 1999:9). The author is of the opinion that some challenges have prompted reforms in a number of countries including the following:

- The budgeting and financial management processes have failed to generate adequate information to assist political decision-making;
- a mismatch has taken place between national vision and departmental priorities and targets;
- the primary focus has been on control and adherence to regulations rather than the promotion of accountability and achievement of results; and
- the roles of budgetary agencies have largely been to specify items of expenditure and monitor compliance with regulations as opposed to strategic planning and monitoring the achievement of outputs and outcomes.

In place of the old paradigm of public administration that was primarily hierarchical decision-making and control driven, the new public sector management environment is characterised by:

- A focus on results in terms of efficiency, effectiveness, quality of service and outcomes;
- a decentralised management environment which better matches authority and responsibility;
- a greater client focus and provision for client choice by the creation of competitive environments within and between public sector organisations and private sector entities;
- the flexibility to explore more cost effective alternatives for service delivery; and
- the accountability for results and related change from risk avoidance to risk management (compare White Paper on Transforming Public Service Delivery 1997:20 and Wynne 2001:18).

It is clear from the above that a paradigm shift has taken place towards financial management reform in the international public sector. This reform will have and already has a significant influence on the developments in financial management in the South African public sector. These developments will now be discussed.

2.5 DEVELOPMENTS IN PUBLIC FINANCIAL MANAGEMENT IN SOUTH AFRICA

The Government has prioritised the transformation of the public sector to enable it to meet the needs of the people and the objectives of the Reconstruction and Development Programme (RDP). Given the enormous demand for services and the limited resources available to satisfy that demand, all available resources should be used as effectively and efficiently as possible. Government is determined to

modernise the management of the public sector, to make it more people friendly and sensitive to the communities it serves (RSA National Treasury 2000:1).

In the past national governments were governed by the Exchequer Act, 1975 (Act 66 of 1975), as amended, whilst provinces were governed by their own Provincial Exchequer Acts (Van der Linde 1999: 18). Financial accountability was undermined by the fact that different legislation was applied. Financial management under these acts was narrowly focused on expenditure control in order to stay within the budget.

Since 1994 particular changes took place in the public financial field. The first was the introduction of the Constitution of the Republic of South Africa, 1996 (Act 108 of 1996) – hereafter referred to as the Constitution; secondly the implementation of zero-based budgeting; thirdly the introduction of the Medium-Term Expenditure Framework (MTEF) and fourthly the proclamation of the PFMA in 1999 that was enacted on 1 April 2000. These developments will subsequently be discussed.

2.5.1 The Constitution of the Republic of South Africa

The Constitution of South Africa requires that national legislation must prescribe measures to ensure transparency by introducing generally recognised accounting practice (GRAP) to the three spheres of government: national, provincial and local. According to Swart (2001:28) this was the right step forward to ensure transparency and openness in respect of public financial management. Section 216(1) of the Constitution furthermore prescribes measures to ensure expenditure control in each sphere of government by introducing uniform expenditure classifications and uniform treasury norms and standards. The Constitution, therefore, provides a base for public financial management reform.

The statements of GRAP will be based on the International Statements of GAAP. The application of GAAP ensures fair presentation and will therefore enhance

transparency and openness. This development obtained an importance rating of 78% among the respondents in the questionnaire.

2.5.2 Zero-based budgeting

The RSA National Treasury (2000:1) indicated that budgetary and financial reforms were initiated soon after the 1994 elections. The first phase of reform began with the introduction of a new intergovernmental system that required all three spheres of government to develop and adopt their own budgets (decentralised zero-based budgeting). This was complemented by a system of significant transfers to provinces and municipalities. Zero-based budgeting has forced departments to review critically their performance in order to motivate for new or more allocations based on proven past delivery (compare Du Randt 1999:10 & RSA Intergovernmental Review 2001:3). This was a step in the right direction as an importance rating of 73% for the implementation of zero-based budgeting was indicated by the respondents in the questionnaire.

2.5.3 Medium-Term Expenditure Framework

The multi-year budgeting by means of the Medium-Term Expenditure Framework (MTEF) was introduced in 1997/98 to replace the one-year incremental system (National Treasury 2000:1). The MTEF has introduced stability in the budgetary process and has enabled departments to plan with long term strategies in mind. This is vital for the sustainability of performance. An importance rating of 79% was given by the respondents for the MTEF development. The implications are that greater emphasis is placed on the output achieved and the resultant outcome, than previously. The requirement for budgets to reflect more measurable targets and performance criteria have therefore increased the need for effective management control systems (compare Dittenhover 2001:451 & Du Randt 1999:10). Flowing from

this statement is the requirement for effective performance measurement which this study is trying to enhance.

2.5.4 The Public Finance Management Act (PFMA)

The rapid change in financial management in the public sector was further marked by the proclamation of the PFMA in 1999. The PFMA development obtained an importance rating of 94% from the respondents in the questionnaire. In this section the aspects of the PFMA, such as the enhancing of budgetary process and the establishment of effective financial management, will be discussed as well as the introduction of Generally Recognised Accounting Practice (GRAP). The treasury regulations are also highlighted.

2.5.4.1 Aspects of the PFMA relating to Public Financial Management

The final element in this phase of reform was to streamline the budget process and to improve the alignment of policy, planning and budgeting. This was achieved with the adoption and implementation of the PFMA. The objective of the PFMA is to modernise financial management and enhance accountability and therefore also corporate governance (compare Du Preez 1999:25-35). This will be complemented by changes to the procurement system.

The PFMA was enacted on 1 April 2000 and introduced a whole new approach to financial management. The purpose of the PFMA is to regulate financial management in the national and provincial government to ensure that all revenue, expenditure, assets and liabilities of government are managed efficiently and effectively; to provide responsibilities of persons entrusted with financial management and to provide for matters connected therewith (PFMA Act 1 of 1999). The purpose of the Act therefore boils down to two elements, namely accountability and responsibilities.

Furthermore, as required by the Constitution, the PFMA introduced Generally Recognised Accounting Practice (GRAP) which includes accrual accounting, lists of responsibilities of government officials and recommended Treasury Regulations. These will briefly be discussed in the ensuing paragraphs.

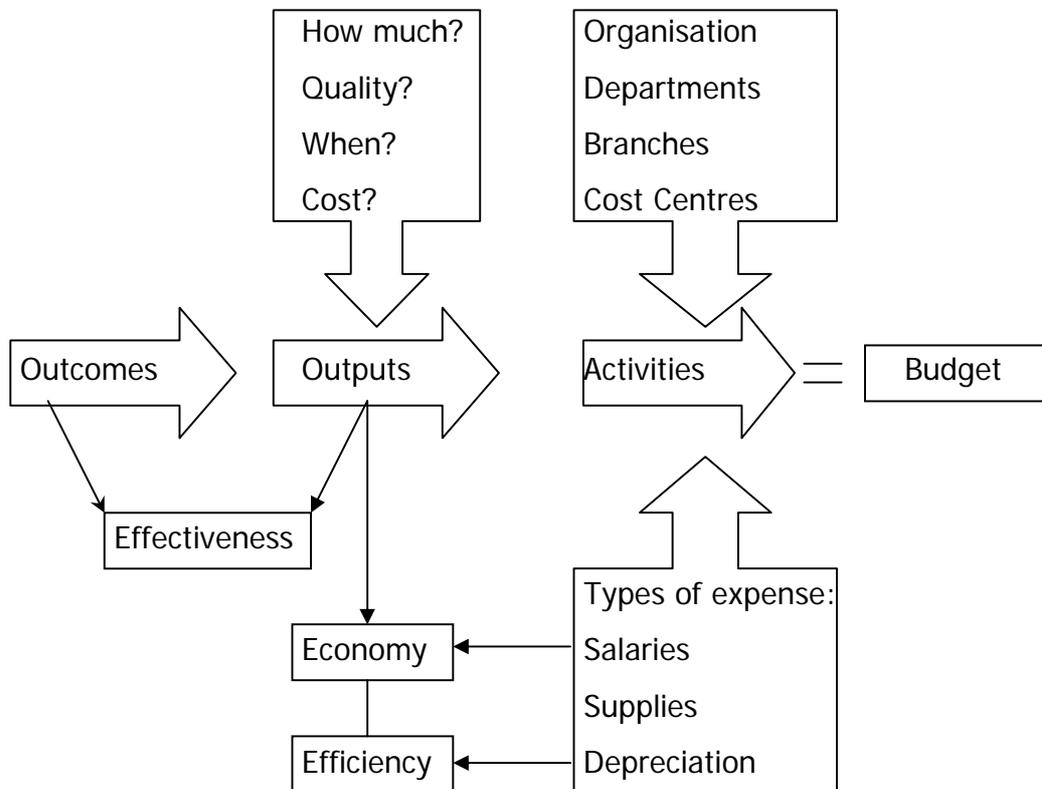
The PFMA is the first phase in a strategy to improve public financial management and will be followed by a focus on efficiency and effectiveness of programmes and best practice financial management (compare Visser 2000:294). These can, however, only be addressed once the basic foundations of financial management are in place. Du Randt (1999:10) referred to these foundations as proper financial control systems and accountability arrangements for the management of budgets.

The PFMA replaced the national and provincial Exchequer Acts, and superseded all other financial management provisions in other Acts (Van der Linde 1999:18). The PFMA adopted an approach to financial management that focused on outputs and responsibilities of officials, rather than the rule-driven Exchequer Act. Du Randt (1999:10) indicated that the PFMA assumes that the political head of a department is responsible for the policy matters and outcomes and that the administrative head - also referred to as the accounting officer - is responsible for the outputs and the implementation of the policies. The accounting officer is accountable to Parliament for the financial management with the implementation of the budget.

For the implementation of the PFMA to be successful, it is crucial that a change in management skills should drive the process. Du Plessis (2001:5) is of the opinion that the implementation will require mindset changes by all stakeholders – such as accounting officers, departmental officials, treasuries, political office-bearers, the Office of the Auditor-General, parliamentarians and legislators. The empirical study showed that 93% of the respondents are of the opinion that management skills will have to change in future whilst 72% felt that leadership styles will also be influenced.

Both finance and non-finance professionals, therefore, should be suitably capacitated to implement the reforms.

If expenditure is brought under control, the major mindset is the long-term challenge and vision for the public sector to become more efficient and effective in the use of resources. This requires a focus on outcomes and outputs (compare Du Randt 1999:9). Outcomes are anticipated results that government wishes to achieve for communities and outputs are statements of goods and services produced by departments for communities. Feinstein (1999:4) indicated that heads of departments are accountable for achieving outputs against a range of predetermined indicators and it is for this reason that they are also referred to as accounting officers. Performance is the efficient, effective and transparent use of resources of departments in provincial governments, the measurement of which is the objective of this study (see chapter three for more detail). These developments in performance measurement that are in harmony with the principles of corporate governance, may be more important than the old traditional accountability by control over expenditure (compare Visser 2000:294). The following diagram best illustrates the long-term vision of the PFMA:

Diagram 1 Long-term vision of the PFMA

(Du Plessis 2001:5)

The three Es of sound financial management, namely effectiveness, efficiency and economy are apparent from the above diagram. The three Es also form the base of performance measurement. It is also clear from the diagram that greater emphasis is placed on the outputs achieved and the resulting outcome than previously where the main focus was on expenditure control. The requirement for budgets to reflect more measurable targets and performance criteria have increased and therefore also the need for effective management control systems (Du Randt 1999:10). Performance measurement in provincial governments should focus, therefore, on the outputs delivered and outcomes achieved in departments which is the objective of this study as reflected in paragraph 1.6 in chapter 1.

2.5.4.2 The introduction of Generally Recognised Practice (GRAP) and accrual accounting

To coincide with the Constitution, the PFMA consequently requires government entities to prepare financial statements in accordance with GRAP. According to section 1, financial statements will at least comprise a balance sheet, income statement, cash flow statement, any other statements that may be prescribed and notes thereto. Sections 87 to 91 of the PFMA also provide for the setting up of an Accounting Standards Board (ASB) to prescribe the standards of Generally Recognised Accounting Standards. According to McCarthy (2003) the ASB has not yet been established.

Before the drafting of the PFMA was initiated, a joint project team was established between Public Finance and Auditing (IPFA), The South African Institute of Chartered Accountants (SAICA), the Office of the Auditor-General and the Department of State Expenditure (DSE) in order to develop perspectives of GRAP (Brown 1999:20). The perspectives to statements of GRAP were developed by using Generally Accepted Accounting Practice (GAAP), which is in harmony with the international standards as a base (compare Pauw et al. 2002:182-183). Brown (1999:21) indicated that the ultimate objective is that GRAP will result in the introduction of full accrual accounting. The empirical study showed that 64% of the respondents are of the opinion that the implementation of accrual accounting will take four years and longer and as such no such implementation took place in any of the institutions at the provincial government sphere that participated in the survey.

The accrual basis provides information regarding such matters as the resources controlled by the entity and the actual cost of its operations. The use of the accrual basis is essential if financial reporting is to provide information useful in evaluating the performance of the government in terms of service costs, efficiency and accomplishments. It, therefore, can assist users by providing better information for

decision-making and accountability and by changing the way in which managers think and operate. The accruals basis is discussed in more detail in chapter six of this thesis.

The Accounting Standards Board (ASB) that is not yet established in accordance with the PFMA, has to harmonise with the international trends. As stated above, the South African government indicated that it will harmonise with the International Public Sector Accounting Standards (IPSAS) of IFAC, which is based on International Accounting Standards (IAS) as its starting point for the development of GRAP. According to Swart (2001:28) significant time saving and benefits will be realised by the harmonisation with IPSAS, given the fact that the private sector is using statements of GAAP that are harmonised with IAS. Furthermore the opinion is held that GRAP, based on IPSAS, will result in credible accounting standards in the public sector.

It should be noted that the implementation of GRAP is not mandatory until required by the National Treasury or the Accounting Standards Board (to be established in terms of the PFMA). However, the financial disciplines in government are encouraged to acquaint themselves with GRAP well in advance of its mandatory implementation.

2.5.4.3 Treasury regulations

In October 2000 the National Treasury issued a Guide for Accounting Officers (CEOs or Heads of Departments) and in April 2001 the Treasury Regulations to help the accounting officers with the implementation of the PFMA. These documents highlight the responsibilities of various officers and financial management procedures on a user-friendly basis. The Treasury Regulations were issued by the National Treasury in terms of section 76 of the PFMA and form part of the Treasury Norms and Standards as required by section 216(1) of the Constitution. With effect from 1 June 2000, these Treasury Regulations replaced the Financial Regulations and Treasury

Instructions issued in terms of the now repealed Exchequer Act, 1975 (Act 66 of 1975). This new financial policy document has legal backing and is applicable to departments and constitutional institutions.

The Treasury Regulations in respect of departments and constitutional institutions (such as special purpose commissions and boards according to schedule 1 of the PFMA) were compiled using a consultative approach, while at the same time taking cognisance of international best practices relating to public financial management. This represents a paradigm shift in the management of public resources, from a rule-driven approach to one that allows accounting officers to make their own strategic financial decisions, thereby promoting accountability and ownership for such decisions (Nair 2000:26).

Due to differing operations among departments and constitutional institutions, the Treasury Regulations were formulated with the intention of providing fundamental best practice financial management principles rather than outlining prescriptive detail, procedures and processes. This inevitably allows the relevant accounting officers to determine the detail, procedures and processes according to the operational needs of his or her department or constitutional institution.

The implementation of the PFMA and the Treasury Regulations signalled a major leap forward in the modernisation of public financial management in South Africa. According to Nair (2000:33) the Treasury Regulations provide a sound framework, in line with best practices in other leading countries, such as Australia, New Zealand and Canada, for proper financial administration and management in government. The Treasury Regulations also emphasise more micro control at institutional level, with the relevant Treasury having macro control over fiscal matters.

The New Public Management concept and the principles of corporate governance were discussed in paragraphs 2.2 and 2.3 and form the base of financial

management in the public sector. The recent local and international developments in public financial management were also discussed. With this available information, attention will be focused on an ideal framework for sound financial management in the public sector with special reference to provincial governments in South Africa.

2.6 SOUND FINANCIAL MANAGEMENT IN PROVINCIAL GOVERNMENTS

Under this heading the objectives of financial management in the public sector will be discussed as well as the current shortcomings of financial management systems. Finally the features of a sound financial management system will be outlined.

2.6.1 The objectives of financial management in the public sector

The objective of a financial management system in the public sector is to support management in their deployment of limited resources with the purpose of ensuring economy and efficiency in the delivery of outputs (services and/or goods produced by entities in terms of quantity, quality, cost and time), required to achieved desired outcomes (effectiveness) that will serve the needs of the community (IFAC 2000: par. 282). Effectiveness, efficiency and economy, therefore, inter alia form the basis of financial management and performance measurement. The Management Advisory Board (1997:10) agrees with this objective by stating that effective financial management is intimately connected to the ability of government to meet the expectations of inhabitants regarding the delivery achievement of government objectives.

Financial management also embraces daily cash management for short-term obligations as well as for the formulation of medium- and long-term financial objectives, policies and strategies, in support of the operational plan of the entity. It includes the planning and control of capital expenditure, working capital management and funding and performance decisions. Financial management supervises the

supporting financial and management accounting functions, internal control environment and supporting financial information systems (IFAC 2000: par. 283).

Financial management is crucial to the successful running of any organisation, as it relates to how the resources available to the organisation are used. In the private sector, financial management inter alia focuses on the examination of alternative sources of finance (means of funding), the effective use of such finance, and cohesion between financial and utilisation decisions (compare Denning 2000:32). In the public sector, financial management inter alia focuses on the prioritisation and use of scarce resources, on ensuring effective 'stewardship' over public money and assets, and on achieving value for money in meeting the objectives of government, that is rendering the best possible services. This must be done transparently and in terms of all relevant legislation (RSA National Treasury 2000:3).

The Guide to Financial Officials issued by the National Treasury (2000:4) stated that public sector organisations could learn from the private sector, where the success and survival of an organisation depend on its financial results. This is not to suggest that the public sector should pursue profits, but rather to acknowledge that public spending is an investment made by taxpayers that should therefore be managed optimally. Several elements of private sector financial management provide a sound basis for practices in the public sector. The implementation of the PFMA and will introduce (Fakie 1999:14):

- Greater alignment of planning and budgeting processes;
- professional contributions to strategic and operational business planning;
- management accounting and reporting;
- a focus on results rather than on processes and rules, but with appropriate internal controls and management of risks; and

- accrual accounting – the insurance that accounting statements reflect the value of resources consumed and benefits provided, rather than simply the timing of cash movements.

Before discussing the main features of financial management, it is necessary to highlight the shortcomings of current financial management systems as these shortcomings are to be addressed in the features of a sound financial management system.

2.6.2 The shortcomings of the current financial management system used in provincial governments

Van der Linde (1999:18) is of the opinion that the core problem to be addressed is where the lack of a sound, modern system of financial management is found. The author highlighted the following weaknesses in the current financial management system:

- No visible linkage exists between strategy, policy, outputs, process, function and resources;
- a lack of performance specification, measurement and accountability arrangements is found;
- accounting is done on a cash basis and no accounting control systems for assets and liabilities;
- inefficient or ineffective internal control systems and weak internal control components are found;
- the lack of an information strategy that will enable the production of Annual Consolidated Financial Statements by all spheres of government;
- the lack of appropriate information technology; and
- a lack of appropriate skills and practical experience in financial management on the part of line managers and financial management practitioners.

The respondents in the empirical study gave a 50% rating to the effectiveness of financial management in the provincial government sector. It is important to note that government officials gave a 53% rating while the external respondents, such as independent auditors, gave a 46% rating. The external auditors, therefore, are more critical regarding the current effectiveness of financial management in the provincial government sector than the government officials themselves. The respondents have listed the following shortcomings of financial management in the provincial government departments:

- Certain functions of financial management are shared by Treasury and these have adverse implications on effective and autonomous operations;
- responsibilities are not clearly defined;
- lack of experienced, knowledgeable, skilled and qualified staff;
- the incorrect placement of staff (not the right people for the job);
- the attitude of staff;
- the capacity to achieve stated goals and objectives effectively;
- the outdated accounting and information systems;
- a lack of knowledge of the PFMA;
- the transformation from financial control/administration to financial management;
- the integration between strategies and budgeting;
- a lack of training;
- the poor flow of documentation and information;
- the inadequate control systems;
- a lack of knowledge of accrual accounting and GAAP;
- a lack of structured policies and procedures in departments; and
- the systems do not support PFMA requirements.

The above shortcomings can be grouped into three categories, namely inadequate and knowledgeable staff; poor integration of budgets and strategies and outdated control and reporting systems. The low rating of financial management in the

provinces that was given by the respondents and the shortcomings listed above should therefore be addressed by provincial governments in order to improve the effectiveness of financial management.

Currently financial management in the public sector is limited to basic appropriation control, driven by a cash budget that facilitates the management of cash inputs. Wheeler (1999:2) emphasised the need to find solutions to one of the most pressing needs in South Africa – an honest and sound financial management system in the public sector. The author continued by stating: “With a few exceptions financial administration in the public sector is not a pretty sight due to lack of up-to-date technology, financial restraints, inadequate financial training and poor internal control systems”.

The shortcomings that are discussed will now be addressed in the formulation of a sound financial management framework. The following section deals with the features of sound financial management.

2.6.3 The features of sound financial management

The Management Advisory Board (MAB) of Australia has done extensive work with regard to effective financial management in the public sector. The Board published a report (1997:39) with regard to a model for financial management for government agencies and highlighted the following features to be included in such a model:

- Accrual accounting, budgeting, management, and reporting;
- professional financial contributions to strategic and operational planning;
- a focus principally on results rather than on process and rules in an environment that displays the existence of appropriate internal controls;
- ex post accountability replacing ex ante control;
- financial management being the responsibility of managers;
- financial advice the responsibility of financial managers;

- excellent information and advice; and
- a professional financial staff.

In the paragraphs below the above features will be linked and compared with the three broad categories of shortcomings listed in the previous section (see Table 3). This will show that by applying the features for sound financial management the shortcomings will be addressed.

The IFAC (2001:par. 284) also dealt with some features of sound financial management and stated that financial management is of a higher standard when it has strong high level support, complemented by a strategy of management for results instead of management for compliance. This strategy of management for results promotes a performance measurement culture that enhances accountability and also corporate governance. The IFAC listed the characteristics of this strategy and are shown below:

- Chief executives and other key staff are on a term contract, supported by performance agreements;
- clearly defined objectives and specified outputs;
- clearly defined responsibility for the chief executive and other participants for resources committed to outputs produced;
- strategic planning and operational plans are introduced;
- central regulations are reduced to the minimum and are replaced with guidelines;
- chief executives are allowed
 - flexibility in the use of resources;
 - discretion to determine cost allocations;
 - full responsibility to determine staffing requirements and remuneration;
- risk management principles are followed;

- accounting practices similar to those employed in the private sector are followed (accrual basis of accounting is adopted);
- incentives are created to ensure improved efficiency; and
- non-financial measures for outputs in terms of quantity, quality and timeliness are introduced and used together with financial measures in the evaluation of performance towards the achievement of pre-determined goals.

One of the objectives of this study as indicated in paragraph 1.6 in chapter one was to identify the features of effective financial management. The empirical study tested all of the above features for their importance in the provincial government sphere. From the feedback of the respondents the following table was prepared to indicate the top 10 features of effective financial management:

Table 2 Top 10 features of effective financial management

Feature	Importance rating
Appropriate internal controls (reducing risks)	1st (98%)
Professional financial staff	2nd (95%)
Excellent information and advice	3rd (92%)
Outcomes-based budgeting	4th (91%)
Financial input to strategic and operational planning	4th (91%)
Financial management the responsibility of managers	6th (89%)
Outcomes-based management (performance agreements)	7th (88%)
Accruals-based accounting and reporting	8th (86%)
A focus on results rather than on processes and rules	9th (83%)
Financial advice and the responsibility of financial staff	10th (81%)

From the above table it is clear that the implementation of appropriate internal controls (reducing risks), the employment of professional financial staff and the availability of sound information and advice are the top three features of effective financial management. Outcomes-based budgeting and the linkage between financial input and strategic planning are also rated highly. All of the above features have ratings of higher than 80% and provincial governments should therefore strive to apply these features, which form the base for performance measurement and the main objective of this study.

If one, therefore, studies the features listed by the Management Advisory Board, IFAC and the results of the empirical study above these features can be grouped into three categories of financial management. These categories are committed and competent line-managers; outcomes based budgeting and accruals based reporting. The three categories were also tested in the empirical study and 97% of the respondents agree with the groupings of the three categories.

These categories also address the three shortcomings that were identified in the previous paragraph, namely inadequate and knowledgeable staff; poor integration of budgets and strategies and outdated control and reporting systems on a line-for-line-basis. The following table illustrates that the three categories of shortcomings are addressed by applying the categories of sound financial management:

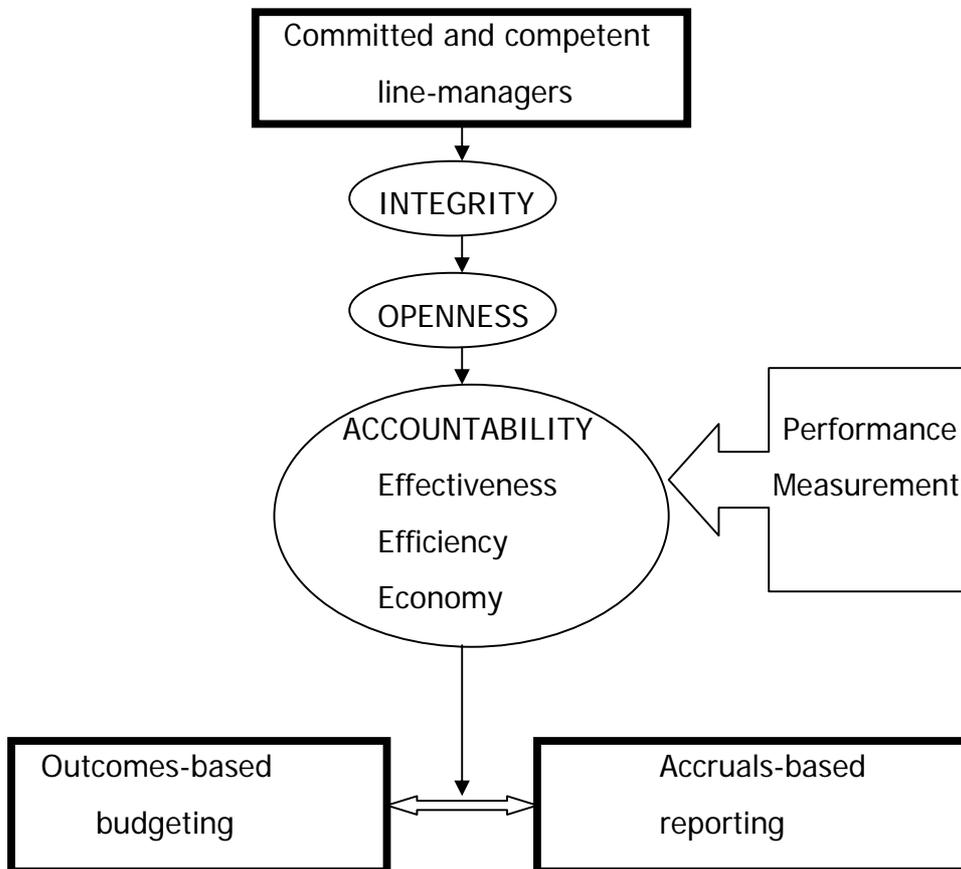
Table 3 How shortcomings are addressed by sound financial management

Three categories of current shortcomings of financial management in the public sector	Three categories of sound financial management in the public sector
1. Inadequate and knowledgeable staff.	1. Committed and competent line-managers.
2. Poor integration of budgets and strategies.	2. Outcomes-based budgeting.
3. Outdated control and reporting systems on a line-for-line-basis.	3. Accruals-based reporting.

In chapter three these three categories of financial management will be identified as prerequisites for performance measurement, an important element of financial management and the objective of this study. Without performance measurement the effectiveness, efficiency and economy cannot be assessed. The accountability principle of corporate governance, therefore, cannot be enforced.

From the three categories of financial management listed above the following diagram can be drawn reflecting the link or inter-relationship with the principles of corporate governance and performance measurement:

Diagram 2 Categories of Financial Management



(Own diagram 2003)

Diagram 2 reflects a triangle of the three categories of financial management, namely committed and competent line-managers, outcomes-based budgeting and accruals-based reporting. These categories can also be seen as the cornerstones of the financial management triangle. The objective of this study is to identify these categories as a solid base for effective financial management.

The three principles of corporate governance and the three Es of financial accountability are also incorporated in diagram 2. A financial management system can only be sound if outcomes are met efficiently and in a cost-effective manner. If

outcomes and outputs are not compared and measured and if outputs are not correctly cost the whole financial management system will fall apart. Without effective performance measurement and reporting the three Es of financial management, namely effectiveness, efficiency and economy will not be accomplished. Performance measurement is used to assess accountability and for this reason the three categories of financial management indicated in the diagram can also be seen as prerequisites of performance measurement and reporting. Line-managers are assessed for accountability for the effectiveness (if outcomes are met), efficiency (if outputs are sufficient) and economy (if outputs are delivered in a cost-effective manner) and should apply the values of integrity and openness in their activities.

The above three categories of financial management boil down to a fully integrated financial management system and represent the prerequisites of performance measurement/reporting, the final aspect of sound financial management. The accounting system that produces the financial statements also needs to be integrated with other management systems such as cash, budget, treasury and debt management. The Management Advisory Board of Australia (1997:12) reported that the Australian government has decided to implement a fully integrated accruals-based resource management framework. This integrated framework will have an explicit focus on outputs and outcomes and thus complement the shift to a performance culture.

2.7 CONCLUSION

In this chapter the New Public Management was discussed with special reference to service delivery to the various stakeholders of government. The principles of corporate governance and the features of effective financial management were highlighted to address the current shortcomings of public financial management.

The empirical study revealed that financial management in the provincial government sector obtained a 53% effectiveness rating by the government officials and a 46% effectiveness rating by the external auditors. Surely this rating is something to be concerned about.

Performance measurement should be an integral part of financial management and should be based on the measurement of accountability by means of the assessment of effectiveness, efficiency and economy, the three Es of financial management. This emphasise the inter-relationship between financial management and performance measurement.

The three principles of new public management and corporate governance, namely openness, integrity and accountability should be seen as a solid base of sound financial management. South Africa should furthermore consider following international trends in financial management. The work done by the Public Sector Committee of the IFAC should be seen as an important reference of what is happening internationally.

It was found that the majority of the respondents (97%) agreed that financial management and performance measurement can only be effective if (i) line-managers are competent and committed; (ii) outcomes-based budgeting is applied; and (iii) accruals-based reporting is introduced in provincial governments. The above three categories are the cornerstones for effective financial management and prerequisites of performance measurement as will be seen in the next chapter.

The need to measure performance as a critical element of financial management is emphasised in this chapter. The use of performance indicators should strike a balance between financial and non-financial indicators. In the next chapter performance measurement will be addressed and the balance between financial and non-financial performance measures will be highlighted.

CHAPTER 3

PERFORMANCE MEASUREMENT IN PERSPECTIVE

3.1 INTRODUCTION

The three categories of financial management were discussed in the previous chapter, namely committed and competent line-managers, outcomes-based budgeting, and accruals-based reporting. The three categories are integrated to form a whole financial management system (see diagram 2 in Chapter two). The logic of these three categories is that managers in the public sector must be committed and competent to plan and budget strategically and must be able to monitor actual results to compare them with the strategic outcomes. In essence this is the basis of performance measurement and the objective of this study.

In this chapter the nature and definitions of performance measurement and performance management will be discussed. The characteristics of performance measures are emphasised and finally a performance reporting statement is proposed that should be incorporated in the financial statements of an organisation such as a department in a provincial government.

3.2 NATURE OF PERFORMANCE MEASUREMENT

Government is increasing its interest in measuring and reporting programme performance and increasing emphasis during budget reviews on programme performance. Moreover, the ability to seek and obtain maximum return from increasingly limited resources can be enhanced by an understanding of the results of the programmes for which budget resources have been expended. In the final analysis, the objective of the government is to provide services, in contrast to the objective of private sector organisations that is to earn profits and enhance the return

on investment, both of which are monetary objectives. All of these factors suggest that a report on programme performance is not only an appropriate financial report, but likely to be the most important report or statement for those persons interested in how a government entity is using its resources (GRAP 1998:4).

The IFAC (2001:par. 215) stated that the public sector is under intense pressure to improve its operations and deliver its products and services more efficiently and at the least cost to the taxpayer. Performance measurement is a useful tool in this regard, since it formalises the process of tracking progress toward established goals and provides objective justifications for organisational and management decisions. Thus, performance measurement can help improve the quality and reduce the cost of government activities.

Notions of public sector accountability have become widely used since the 1990s. Kloot (1999:567) said that performance reporting is necessary for the discharge of accountability and that financial and accounting information is often emphasised in determining accountability. Kloot (1999:567) argued that accountability is not measured by financial measures only, but should also include non-financial measures. Kaplan and Norton (2001:87) agree with this by stating that the exclusive reliance on financial measures could promote behaviour that sacrifices long-term value creation for short-term financial performance. The IFAC (2001:par. 315) also stated that financial statements prepared on the accrual basis of accounting are primarily limited to data that are both historical and financial. This information is often not responsive to all the decision-making needs of users, who also need forward-looking and non-financial information. The balanced scorecard that will be discussed in paragraph 3.7, has a strategic analysis perspective and will be an ideal tool to facilitate the balancing act between financial and non-financial information and measures. The performance report based on the balanced scorecard will be discussed in paragraph 3.8.

The IFAC (2001:par. 320) indicated that in the private sector, the inputs and outputs (purchases and sales) are automatically defined in monetary terms. Profit, essentially the difference between them, is to some extent a measure of the degree to which a business has achieved its objectives. For both private sector and public sector entities, inputs can usually be measured in monetary terms. However, a measurement difficulty may exist with regard to the outputs and outcomes of a public sector entity, due to multiple, non-financial objectives.

The IFAC (2001:par. 317) stated that in order to improve performance, it is also necessary to measure performance in non-monetary terms. Without information about what is being delivered (outputs), what it is costing (inputs), and what is achieved (outcomes) it is impossible to make efficient resource allocations within the public sector. The objectives of performance measures include responding to accountability requirements, improving service delivery, and reducing costs while maximising output and increasing productivity in the entity.

Seventy-nine per cent (79%) of the respondents in the empirical study indicated that outputs are measured by provincial government departments. The cost effectiveness of these outputs cannot be measured at all as these outputs cannot be cost accurately by using the cash basis of accounting. Therefore it will be impossible to apply performance measurement at provincial government departments if accrual accounting is not implemented.

Performance measurements also have a significant role in managerial or internal control, in ensuring that organisations are managed in the best interests of all the stakeholders. Performance measurement, therefore, is important for both external and internal accountability and a handy tool to managers.

A clear understanding is needed of performance measurement. The next section deals with the definitions of performance measurement and management.

3.3 DEFINITIONS OF PERFORMANCE MEASUREMENT AND MANAGEMENT

Armstrong and Baron as quoted by Mwita (2000:20) stated that 'If you can't define performance, you can't measure or manage it.' Otley (1999:364) referred to performance as being about doing the work, as well as being about the results achieved. Fitzgerald and Moon as quoted by Mwita (2000:21) argue that performance should be defined as the outcomes of the work because they provide the strongest linkage to the strategic goals of an organisation, customer satisfaction, and economic contributions. Wang (2000:104) defines performance measurement as the measuring of levels of activities and achievements by means of a range of indicators. Du Randt (2000:15) indicated that performance measurement should eventually lead to performance management, which is a tool of transforming ideas, vision and mission of senior managers into actions that can be planned for, measured, modified and corrected.

From the above one can define performance measurement as the comparison of outcomes of activities or processes with the strategic goals of an organisation. The comparing of actual results with strategic outcomes represents performance measurement. Performance measurement therefore strengthens the principles of corporate governance as it promotes accountability and openness to stakeholders. Performance management is the continuous process of measuring outputs against strategic plans and the changing and modifying of actions to achieve the goals of an organisation (compare Grobler et al. 2002:260).

Seeing that performance measurement is the comparison of actual outputs and outcomes with the strategic goals, the importance thereof should be discussed in more detail. The next section highlights the link of performance measurement and strategic planning.

3.4 THE LINK BETWEEN PERFORMANCE MEASUREMENT AND STRATEGIC PLANNING

Performance measurement is the link between what is set out to do and what is actually achieved. It is, however, critical that an organisation ensures that this loop is closed. Unless performance is controlled and reported, and feedback into the new planning cycle is provided, continuous performance will not take place (Du Randt 2000:12).

In the Guide for Annual Reporting of National Treasury (2000:1) it is clearly stated that strategic planning cannot be developed in isolation, but should rather be the result of thorough consultation with all relevant stakeholders. The following must be aligned to and be consistent with the strategic plan:

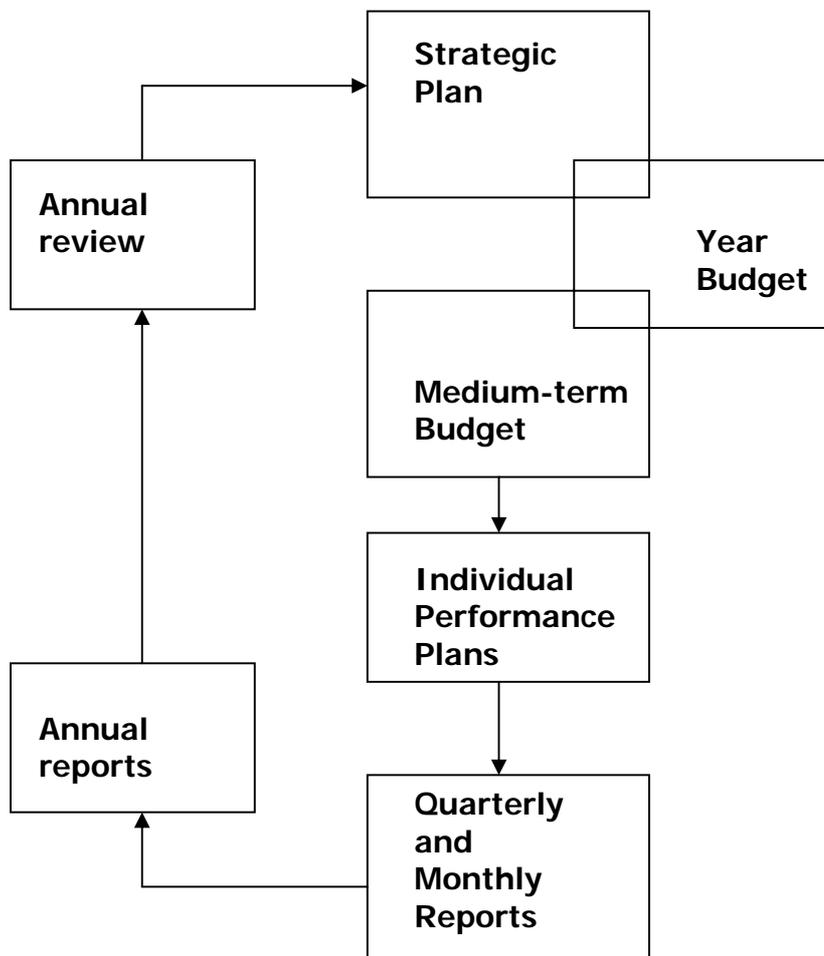
- Estimates of expenditure;
- performance contracts between a Minister/MEC and the head of the department;
- performance contracts between the head of a department and senior managers;
- service delivery improvement programme; and
- departmental annual reports.

From the above it is clear that performance measurement and the strategic plan of provincial government departments should be in harmony. The RSA National Treasury (2000:3) continued by saying that it is evident that the accountability process culminates with the publishing of the annual report that serves to inform the citizens of the country as to what progress government has made in the achievement of its objectives. Accounting officers, therefore, are required to compile annual reports for the organisations that they are responsible for and these annual reports must fairly represent the performance and financial position of an organisation for a

particular fiscal year. The information contained in the annual report should therefore reflect the achievements of a provincial government department in relation to the objectives as set out in the strategic plan and annual budget of an organisation for the fiscal year in question. If this comparison can be made, the performance measurement objective of this study can be fulfilled.

The following is a diagrammatic representation of the planning, budgeting and reporting cycle of an organisation:

Diagram 3 Planning, budgeting and reporting cycle



(RSA National Treasury Guide on Annual Reporting 2000:2)

From the above diagram it can be deduced that the strategic plan, which includes budget information, is for three years and should be updated annually. The annual budget is the next step and has a detailed focus on a particular year of the strategic plan and includes output and service delivery information. The medium-term budget explains the strategic direction and includes expenditure trends and three-year forward estimates. The outcome of the previous year is used when deciding on resource allocation. Individual performance plans are aligned with the budget and include staff performance contracts and individual development plans that are clearly linked to departmental key objectives and outputs. It also indicates individual contribution towards achieving departmental objectives.

The quarterly and monthly reports incorporate the progress measured against the budget and strategic plan and highlights departmental performance (financial and non-financial) against the objectives. The annual report indicates the performance measurement against the budget, which is based on the strategic plan. The annual report must also meet reporting requirements of National Treasury and the Public Service Regulations and will incorporate environmental changes, expenditure outcomes and new budget allocations. The annual report will also provide for strategic direction changes and completes the cycle. Financial reporting should include performance measurement and will be discussed in chapter six. Performance measurement is a definite part of the reporting cycle and the objective of this study.

Du Randt (2000:12) stated that performance measurement process, which serves as the monitoring and controlling function within the organisation, is strongly tied to financial management. This statement highlights the objective of this study because performance measurement procedures strengthen financial management. The success of financial management is linked to three critical processes, namely (compare Adams & Neely 2002:30):

- Strategic planning: Without it one cannot have effective operational plans;

- operation planning: Without it one cannot have sensible performance contracts for staff; and
- performance contracts: Without quantified goals in operational plans and the linkage thereof to performance contracts, one cannot have effective financial management.

The above requirements are the core elements of performance measurement. It is clear from the above that contractually committed staff is a prerequisite of performance measurement. Committed and competent line-managers were identified as one of the three categories of financial management (see chapter two) and can now also be seen as a prerequisite for performance measurement which will be discussed in chapter four of this thesis. It is also evident from the above that operating plans or budgets cannot be prepared without using the strategic plan as a base. Outcomes-based budgeting (can also be described as strategic-based budgeting), one of the three categories of financial management as indicated in chapter two, can therefore also be regarded as a prerequisite of performance measurement and will be discussed in chapter five of this thesis. Furthermore, if performance is not measured and controlled, the effort to formulate strategic plans will be of no use. In order to measure performance, it should be reported in relation with the strategic plan. A link should therefore exist between performance reporting and the strategic plan. For this reason reporting is a further prerequisite of performance measurement and will be discussed in chapter six of this thesis.

From the above, committed staff, outcomes-based budgeting and reporting could be regarded as prerequisites of performance measurement. As strategic planning outlines performance measurement and reporting formats, it is crucial to analyse the strategic planning process. In the next section strategic planning will be discussed in more detail.

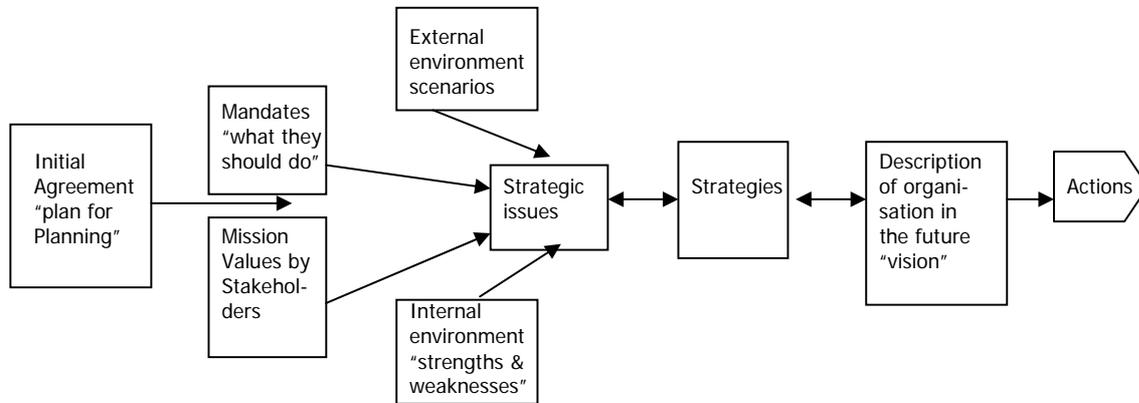
3.5 STRATEGIC PLANNING

As strategic planning, and hence also outcomes-based budgeting, is a prerequisite for performance measurement it is necessary to collaborate on strategic planning. Strategy will be defined first and then the process of strategic planning and requirements by National Treasury will be looked at.

Garrison and Noreen (2000:464) define strategy as a theory about how to achieve the goals of an organisation. Strategic planning focuses on the identification desired outcomes and outputs. Desired outcomes are results the government wants to achieve for the benefit of the communities, for example reduce road accidents and lower crime rates. These outcomes are the articulated vision of the government and provide an indication of the intended affect of activity of government on the community (compare Du Randt 2000:11 and MAB 1997:15). Desired outputs are the services and products that are to be produced by an organisation and provided to external users, to satisfy the desired outcomes. Without the identification of desired outputs and outcomes, performance measurement will be impossible as no benchmark will exist to compare the actual outputs and outcomes.

In the strategic planning process emphasis needs to be placed on identifying objectives, priorities and activities. The format of the budget documents should provide a clear explanation of the rationale (strategic plan and policy) for the proposed allocation of resources. Where possible, public feedback is taken into account in the formulation of the strategic plan (compare IFAC 2001:par. 275).

The following diagram shows the process of strategic planning:

Diagram 4 Strategic planning process

(Bryson & Roering 1987:10)

Strategic planning deals with the interpretation of stakeholder requirements and expectations as well as with organisational and environmental issues and the formulation of plans to meet these requirements and address these issues (compare Glad & Becker 1994:159). It is a review of the critical issues facing the organisation and the identification of the strategies to be implemented. The following critical issues were listed by the respondents of provincial government departments in the empirical study:

- Job creation;
- poverty;
- establishment of internal control unit and audit committee;
- monitoring of police conduct;
- transformation;
- use of financial and human resources;
- continuous training of staff;
- capacity building to achieve goals by service delivery;
- create and maintain essential infrastructure; and

- linking of costs services and values.

The IFAC (2001:par. 273) states that it is often impossible to achieve the objectives within one year, thus it is necessary to have long-term plans to ensure that the best use is made of resources. In South Africa the annual budget should be linked to a medium term expenditure framework (a plan that usually covers a period of about three to five years), containing measurable statements of the objectives of the public sector entity, policies and priorities, strategies for achieving the objectives, and a resource framework to plan for the period (projections of revenue and ceilings).

According to the RSA Treasury Regulations (2001:15) approved strategic plans must be tabled in Parliament or the relevant provincial legislature within 15 work days after the Minister or relevant MEC for finance has tabled the annual budget. The strategic plan must:

- Cover a period of three years and be consistent with the published medium term expenditure estimates of the institution;
- include the measurable objectives and outcomes for the programmes of the institution;
- include details of proposed acquisitions of fixed or movable capital assets, planned capital investments and rehabilitation and maintenance of physical assets;
- include details of proposed acquisitions of financial assets or capital transfers and plans for the management of financial assets and liabilities;
- include multi-year projections of income and projected receipts from the sale of assets;
- include details of the Service Delivery Improvement Programmes;
- include details of proposed information technology acquisition or expansion in reference to an information technology plan that supports the information plan; and

- include the requirements of Chapter 1, Part III B of the *Public Service Regulations*, 2001.

The South African Government is moving in the right direction because it is forcing departments to strategically plan ahead for at least three years (RSA National Treasury 2000:1). The identification of measurable objectives and outcomes are necessary to link the strategic planning and budgets with performance measurement which is the main objective of this study.

The RSA Treasury Regulations (2001:15) continue by stating that the strategic plan must form the basis for the annual reports of accounting officers as required by sections 40(1)(d) and (e) of the PFMA. This also emphasises the requirement that the budgeting and accounting systems should be in total harmony in provincial government departments.

Respondents in the empirical study also indicated that the lack of linking strategic plans with the budgets is currently a serious shortcoming in provincial government departments. Seeing that budgets that are not linked with strategic plans, are used as a performance measurement tool, performance measurement is not in harmony with the strategic plans of provincial governments.

Performance measurement with a clear identification of how performance will be measured is a critical prerequisite for the control or accountability process. In the next section the characteristics of performance measures will be discussed.

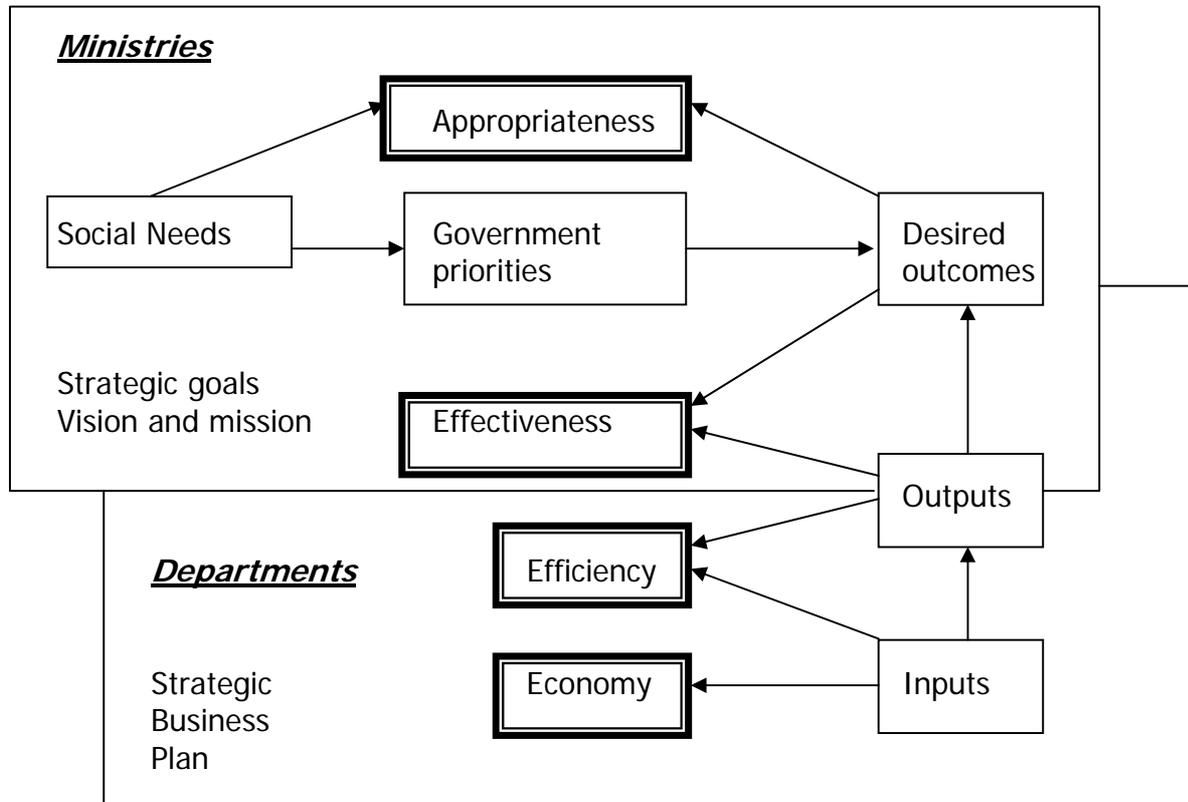
3.6 CHARACTERISTICS OF PERFORMANCE MEASURES

Performance measures are the indicators or predetermined targets that are used to measure performance. These measures indicate to management the areas where it

is going to plan and where to make changes or adaptations in order to meet the strategic goals of an organisation. The three Es of financial management are touched on in chapter two. Kloot (1999:569) referred to the three Es and appropriateness as what performance measures usually take into account:

- *Economy* — refers to the acquisition of the appropriate quality and quantity of financial, human and physical resources at the appropriate time and place and at the lowest possible cost;
- *efficiency* — refers to the use of resources so that output is maximised for any given set of resource inputs, or input is minimised for any given quantity and quality of output provided;
- *effectiveness* — refers to the extent of the achievement of set or predetermined outcomes, objectives or other intended effects of programmes, operations, activities or processes; and
- *appropriateness* — whether the objectives or outcomes of programmes, operations, activities or processes address the real needs of customers.

Du Randt (2000:12) differentiates between ministries and departments and incorporated all the above to indicate how economy, efficiency, effectiveness and appropriateness represent the cornerstones for the comparisons between social needs, desired outcomes, outputs and inputs. The author illustrates these concepts as follows:

Diagram 5 Performance measures: Objectives and Indicators

Du Randt (2000:13)

The goals and objectives of the ministries and provincial departments should be in total harmony. From the above diagram it is clear that the building blocks, namely inputs, outputs and desired outcomes are compared with the strategic goals, vision and mission of the ministries and form the basis of performance measurement and the objectives of this study. The outcomes and social needs are analysed for appropriateness. The outputs and outcomes are compared for effectiveness while the inputs are compared with the outputs for efficiency. The inputs are critically analysed for cost effectiveness (economy) in the delivery of outputs. The ministries will measure effectiveness of outcomes to satisfy social needs while departments in provincial governments will measure efficiency and economy with regard to outputs delivered.

The IFAC (2001:par. 330) classified performance measures for public sector entities into the following three different categories (compare Parmenter 2002:66):

- Process measures — measures of activity carried on by the entity (“means” oriented);
- results measures — measures related to the objectives of the entity (“ends” orientated); and
- social indicators — broad measures of outcomes that significantly reflect the work and affect of the entity.

Performance measures should be predetermined and should be available for all stakeholders to see (compare Adams et al 2002:32). Without some discipline and standardisation regarding the choice of measures, measures may be chosen only to show the performance of the entity in a favourable light and not its actual performance over a broad spectrum of objectives.

Performance measures need to be quantified in terms of identified goals in a time constraint. Even though quality may be difficult to measure, performance measures should attempt to reflect both quality and quantity (compare Johnson 2001:321).

A basis of comparison is needed for performance measures. The most usual bases of comparisons are with previous years, with similar entities and with budgeted targets. Where comparisons over time are made by a particular entity, then a consistent basis of measurement should be used (IFAC 2001:324).

Performance measures should also be relevant, understandable, reliable, complete, objective and neutral, timely and comparable. A balance or trade-off between these qualitative characteristics may often be necessary. Judgement will be necessary in the selection of appropriate performance measures. Effective performance measures take time to design, implement and perfect. A performance measurement system needs to be approached as an iterative project in which continuous improvement is a

critical and constant objective (compare Parmenter 2002:66 and IFAC 2000:par. 326).

As can be deduced from the above, performance measures in provincial government departments should both be financial and non-financial. These measures should be in balance and in harmony with each other. In the next section this harmony will be highlighted with the use of the balanced scorecard within the performance reporting model.

3.7 THE BALANCED SCORECARD AS PERFORMANCE REPORTING MODEL

The performance reporting model is based on the balanced scorecard because it links the strategic goals of an organisation with the desired outcomes and outputs.

Financial performance measures on its own do not equal the best measures of organisational performance. The exclusive reliance on financial measures in a management system is insufficient. Financial measures are historic indicators that report on outcomes of past actions. Kaplan and Norton (2001:87) are of the opinion that the balanced scorecard approach retains measures of *past* financial performance, but supplement these with measures on drivers and lead indicators of *future* financial performance. From this one can promote a performance statement that can be included in the annual financial statements that harmonise the balance scorecard with the income statement.

The balanced scorecard is a valuable tool for organisations in both the public and the private sectors that wish to drive a process of strategic change (MAB 1997:54). This provides focus on performance measurement that balances the financial and non-financial indicators of performance.

Garrison and Noreen (2000:464) defined a balance scorecard as an integrated set of performance measures (quantifiable targets and outputs) that are derived from the strategy of an organisation. The opinion is also held that a balanced scorecard consists of an integrated set of performance measures that are derived from the strategy of an organisation. The MAB (1997:50) defines the balanced scorecard along the same lines and indicate that it is an approach to performance measurement that translates the strategic objectives of an organisation into a useful set of performance measurements. From these definitions it is clear that a close link exist between strategy and performance measurement.

The balanced scorecard is based on the strategic planning process of an organisation. In Chapter two strategic planning was identified as one of the important features of sound financial management, that is the objective of this study.

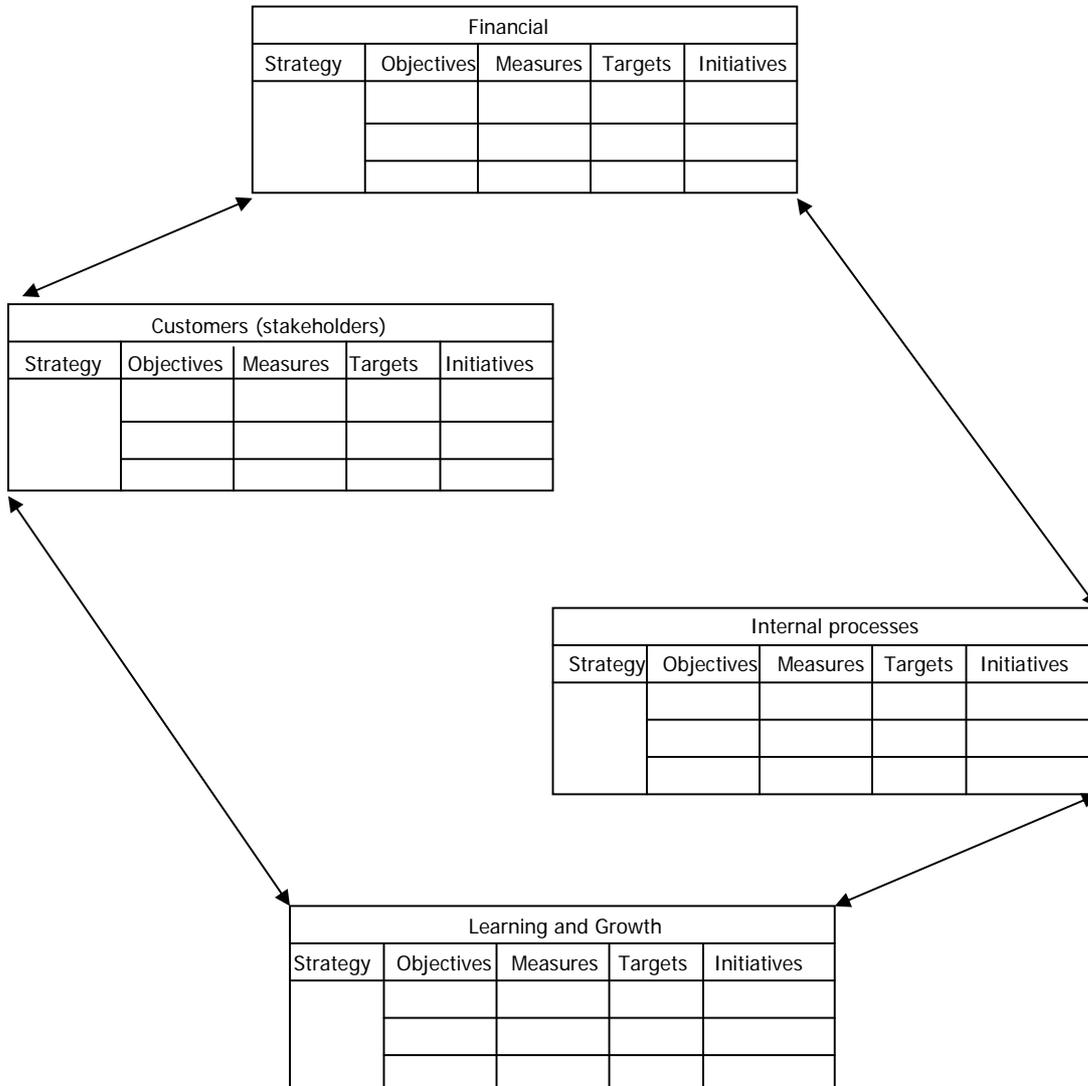
The balanced scorecard is a management tool that can be used to document strategies of an organisation as discussed in paragraph 3.5 above. The MAB (1997:54) is also of the opinion that the balanced scorecard harnesses the strategic vision of the organisation in a holistic view of the key drivers of success, and closely integrates the strategic vision with the operational planning and budgeting activities of the organisation.

Strategic planning, as was discussed above could be facilitated by using the balanced scorecard as a base. Any organisation has four strategic objectives to balance its overall goal and vision. The balance scorecard integrates the following four areas of strategies of an organisation (compare Drury 2001:492 and Garrison & Noreen (2000:465):

- **Financial** : What are the financial goals? The strategy for how to achieve financial goals from the perspective of the executive authority.

- **Customer/stakeholder:** What customers/stakeholders will be served and how are they going to be satisfied? The strategy for creating value and differentiation from the perspective of the customers or stakeholders.
- **Internal operating process:** What internal business processes are critical to providing value to the customers? The strategic priorities for various internal processes that create stakeholder satisfaction.
- **Learning and growth:** What is done to maintain the ability to change and improve? The priorities to create a climate that supports organisational change, innovation and growth.

Drury (2001:494) suggested three or four objectives under each perspective. It is clear from the diagram below that the strategic objectives, the performance measures to track these objectives, the targets for achievement against each objective and initiatives are closely linked and in harmony with the vision and strategies of the organisation. This can be illustrated as follows:

Diagram 6 The balanced scorecard: Four perspectives

(compare MAB 1997:50 and Drury 2001:494)

The four perspectives of the balanced scorecard are subdivided into four elements that is called the strategy map:

- Strategic objectives;
- measures for performance to track each objective;
- targets for achievement against each objective; and

- initiatives to be undertaken.

Kaplan and Norton (2001:91) are of the opinion that the logical architecture of a strategy map creates a common and understandable point of reference for all organisational units and employees. The MAB (1997:51) stated that the balanced scorecard also serves to focus the attention of management on a smaller number of critical performance indicators, getting away from measuring everything, to deciding what are the key measures for the particular organisation.

The four perspectives of the balance scorecard give a broad view of the critical and most important strategies of an organisation and will also indicate how the outcome of the strategies will be measured, an important feature for performance measurement as highlighted in the objectives of this study.

The vision of an organisation, however, is often not adequately communicated and aligned to its strategic objectives; strategies are not aligned with divisional operating plans and individual performance plans and the budget process is not linked to corporate strategy and performance information. These are also indicated as shortcomings of the current budgetary systems used in provincial government departments (see paragraph 5.4). The balanced scorecard can therefore be used in provincial government departments to overcome these problems because it focuses the attention of management on a smaller number of truly critical strategies and their performance indicators.

The MAB (1997:50) suggested that performance information should provide a balance between financial and operating indicators and should include data that highlight areas for growth and improvement. Garrison and Noreen (2000:464) continued by saying that under the balanced scorecard approach, top management translates its strategy into performance measures that employees can understand and can do something about. Rayburn (1996:13) stated that these performance

measures should encourage managers to achieve overall organisational goals. To do this, the author continues, an organisation should break down its goals into sub-goals or objectives for individual managers. These objectives should be in harmony with the overall goals of an organisation. Cirillo (2001:53) argues that managers of government departments have more pressure to perform and that they need to think more about outcomes that have to be delivered and whether resources are utilised efficiently to produce these outcomes.

What you measure is what you get. The MAB (1997:50) is of the opinion that measurement systems introduced by organisations do more than measure performance, they also influence the behaviour of those being measured. Performance measurement systems also motivate people to perform because they know how they will be evaluated. If people know that they will be judged on certain results they are likely to change their behaviour to maximise performance in those areas. According to Kaplan and Norton (2001:87) the results of the scorecard should be circulated widely to foster a performance culture within an organisation.

Kaplan and Norton (2001:87) implemented the balanced scorecard at various organisations and responded as follows: "Since introducing the balanced scorecard in 1992, we have helped over 200 executive teams design their score card programmes. Initially we started with a clean sheet of paper. Asking, What is the strategy?, and allowed the strategy and the Balanced Scorecard to emerge from interviews and discussions with the senior executives." The question can now be asked whether the balanced scorecard can also be applied in the public sector. The empirical study showed that the use of the balance scorecard in provincial government departments is virtually non-existent. Only 13% of the respondents indicated that their departments make use of the balanced scorecard. Seventy-one per cent of the respondents, however, indicated that it will be possible to apply the balanced scorecard in provincial government departments. The other 29% retained their opinion and did not indicate that they were negative about the application. According

to the respondents it would therefore be possible to implement the balanced scorecard in provincial government departments.

An extension of the balanced scorecard sees it integrated into the overall strategic management system of an organisation (compare Gering & Mntambo 2002:36). Used this way, the balanced scorecard model tackles the problem of low success rates of strategic change programmes in organisations (MAB 1997:51). These low success rates often occur because of a lack of integration of the planning process and actual activity.

The link between corporate planning and operational activity is essential for effective performance measurement, an objective of this study. To accomplish this link, management needs to implement four key processes:

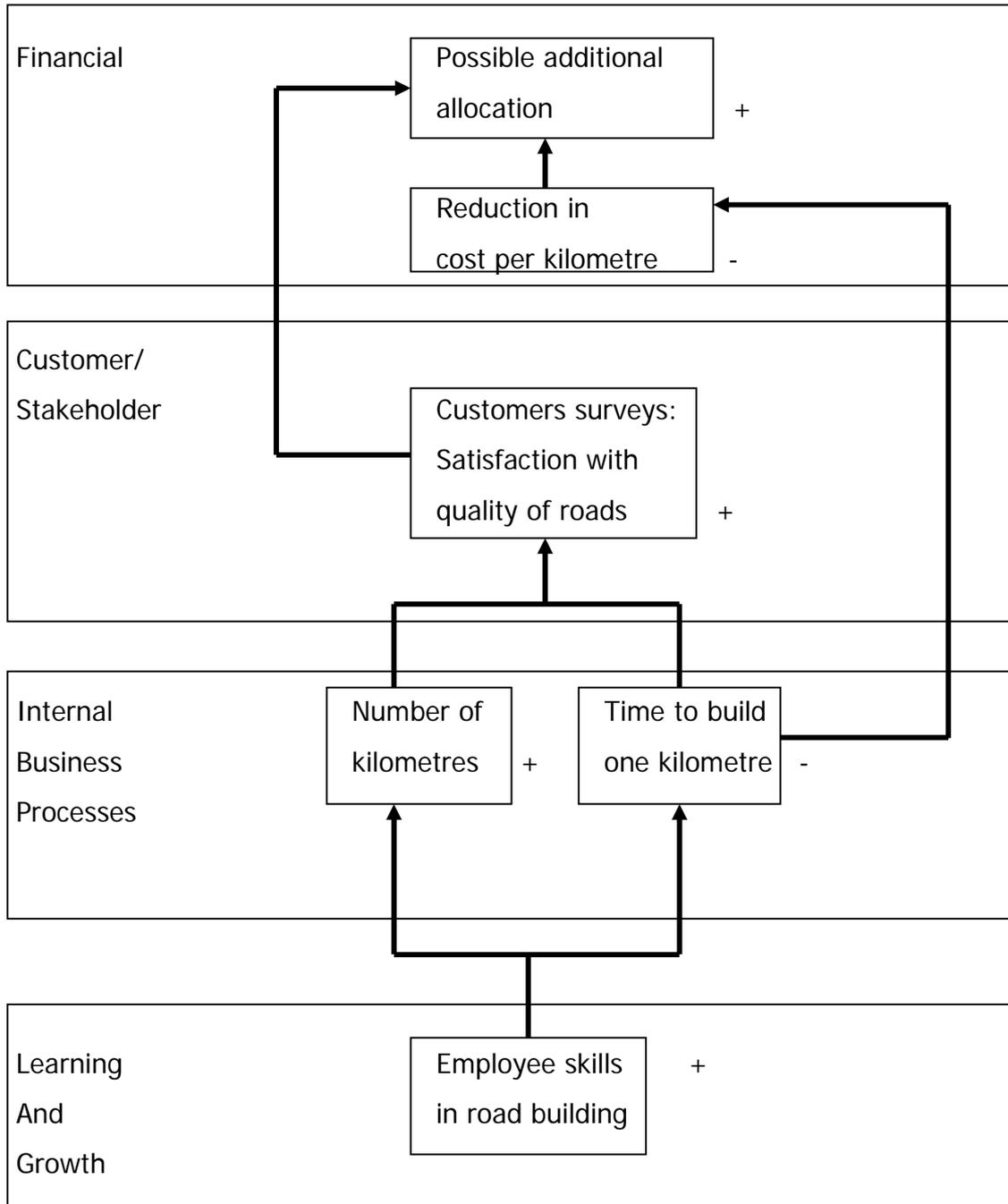
- Translating the vision;
- communicating and linking;
- operating/process planning; and
- feedback and learning.

These linkages are shown in diagram 7 below:

Diagram 7 Managing strategy: Four processes

(MAB 1997:51)

If the operational performance is boosted it will automatically enhance financial performance in current and future years. Garrison and Noreen (2000:467) are of the opinion that if the balanced scorecard is correctly constructed, the performance measures should be linked together on a cause-and-effect basis. Each link can be read as a hypothesis in the form "If we improve this performance measure, then this other performance measure should also improve". The following diagram illustrates this concept by using the building of roads as an example:

Diagram 8 Implementing the balanced scorecard

(Garrison & Noreen 2000:467)

The logic of the above diagram is that if the employees acquire better skills to work more effectively, then the organisation can build more roads in less time and the stakeholders should show greater satisfaction with the roads available to them. If stakeholder satisfaction improves, the organisation can have better grounds to tender for a bigger allocation and hence will improve the financial result. In addition, if the time of building the roads decreases, the cost per kilometre road should also decrease and improve the financial result. From this diagram it is apparent that the financial result is directly or indirectly affected by the performances of operating dimensions of the organisation, namely stakeholder satisfaction, internal business processes and learning and growth. The importance hereof will be illustrated under paragraph 3.8 where a performance report will be developed that harmonises the income statement and the balanced scorecard.

In essence, the balanced scorecard articulates a theory of how the organisation can attain its desired outcomes, financial, in this case, by taking concrete actions (Garrison & Noreen 2000:468). While the strategy laid out in Diagram 8 seems plausible, it should be regarded as only a theory that should be disregarded if it proves to be invalid. For example, if cost per kilometre did not drop because of the increase in skills of the workers, the strategy should be reconsidered.

The balanced scorecard has the following potential benefits for provincial government departments (MAB 1997:54):

- It provides managers with complex information at a glance;
- it ensures that managers are managing all important variables – not just the easy ones;
- it balances time perspectives – current performance as well as the drivers of future performance; and
- it prevents information overload by limiting the measures used.

Kaplan and Norton (2001:91) further believe that the balanced scorecard can be just as useful as the traditional framework of income statement, balance sheet, and cash flow statement. Indeed, as it will be discussed in the following section, the balanced scorecard can be integrated in a performance report that harmonises with the income statement and these other statements.

The RSA National Treasury (2000:22) published a guide on annual reporting and indicated clearly that the annual report will be the basis for evaluating achievements, and accounting officers will be responsible for delivering clearly specified outputs. The Office of the Auditor-General will focus on performance as well as compliance auditing. In addition to examining the post-audit review, legislators will play a greater role in monitoring the performance of accounting officers during the financial year.

A kind of performance reporting, therefore, is required by National Treasury and should be on an annual basis. In the next section a performance report in a form of a statement that harmonises with the income statement is promoted.

3.8 THE PERFORMANCE REPORT

This section indicates that the principles of a balanced scorecard can be incorporated in a performance statement that can be included in the annual report and harmonises with the objectives set for this study.

In section 1 of the PFMA the composition of financial statements is addressed and should include a balance sheet, income statement, cash flow statement, notes and any other statement that might be required. This thesis promotes the performance report to be utilised as the "other statement".

Ninety-six per cent (96%) of the respondents in the empirical study are of the opinion that a performance report or statement should be part of the annual financial statements. Therefore a need has been clearly identified for such a statement at provincial government departments.

As discussed in this chapter the balance scorecard is a useful performance measurement tool. It combines operating and financial performance measures. The income statement is the primary financial performance measurement statement. Seeing that financial performance is affected by the three operating perspectives, one can promote a statement that combines the balanced scorecard with the income statement.

The scorecard supplements the traditional financial measures with information on the following three additional perspectives of operational performance, namely:

- Customer/stakeholder satisfaction;
- internal business processes; and
- innovation and learning.

The empirical study revealed that 89% of the respondents are of the opinion that apart from the financial perspective any organisation could be divided into the above three operational perspectives. It is possible, therefore, to apply the different perspectives of the balanced scorecard in provincial governments.

The proposed performance statement is reflected in paragraph 7.3 of chapter seven, and shows all the cost of the various outputs that are required for the proposed objectives of the three operating strategies. Unallocated expenses are shown separately on the statement. The allocations received are also disclosed as income.

The planning and budget processes will prescribe the strategies, objectives, measures and targets as well as the activities that are needed to meet the objectives. It is therefore important that the budget identifies the required performance measures to ensure that the targets are communicated well in advance. The performance statement should therefore also reflect the budgeted figures for comparison purposes.

The performance statement should reflect the same surplus or deficit as disclosed in the income statement. This will provide an audit trail between the income statement and performance statement and will make the financial statements more understandable and user-friendly. (See chapter seven for the proposed implementation of the performance statement that harmonises with the balanced scorecard and which should be included in the annual financial statements).

3.9 CONCLUSION

Provincial government departments need to establish and report on relevant performance measures to ensure and demonstrate that all resources have been procured economically and are utilised efficiently and effectively. The balanced scorecard is a promising approach to managing organisations because it consists of an integrated system of performance measurement that uses measures that are derived from specific strategies of an organisation. The balanced scorecard forms the basis of performance measurement and is the main objective of this study as indicated in paragraph 1.6 of chapter 1.

The balanced scorecard technique should be used by provincial government departments to measure performance. This will create harmony between the strategy analysis and the actual outputs. Only 13% of the respondents indicated that their departments make use of the balanced scorecard. 71% of the respondents, however, indicated that it will be possible to apply the balance scorecard in provincial

government departments. The use of the balanced scorecard can enhance managerial control and accountability in provincial government departments.

The need to report on financial and non-financial information was emphasised in this chapter. The performance measures should be a balance between financial and non-financial information and therefore a performance statement that combines the balanced scorecard and the income statement was proposed. Ninety-six per cent (96%) of the respondents agree that the performance statement should form part of the annual financial statements of provincial government departments as required by section 1 of the PFMA. This will provide an audit trail between the desired outcomes and the actual performance of provincial government departments.

Committed and competent line-managers were identified as one of the three categories of financial management in chapter two and were also identified in this chapter as a prerequisite for performance measurement as staff members are required to be contractually committed to perform. Committed and competent line-managers as a prerequisite for performance measurement will be discussed in the next chapter of this thesis.

It is also evident from this chapter that operating plans or budgets cannot be prepared without using the strategic plan as a base. Outcomes-based budgeting, that can also be seen as strategic-based budgeting and one of the three categories of financial management as indicated in chapter two, can also be regarded as a prerequisite of performance measurement. Outcomes-based budgeting will be discussed in chapter five of this thesis.

Furthermore, if performance is not measured and controlled, the effort to formulate strategic plans will be of no use. In order to measure performance, performance should be reported in relation to the strategic plan. Therefore a link should exist between performance reporting and the strategic plan. For this reason reporting is a

further prerequisite of performance measurement and will be discussed in chapter six of this thesis.

The next three chapters will deal with the three prerequisites of performance measurement of financial management namely, committed and competent line-managers, outcomes-based budgeting and accruals-based reporting.

CHAPTER 4

PREREQUISITE FOR PERFORMANCE MEASUREMENT: PART 1

COMMITTED AND COMPETENT LINE-MANAGERS

4.1 INTRODUCTION

An affective corporate framework, focused leadership, astute line-managers and a professional finance team are the key ingredients of a performance oriented organisation. The establishment or refinement of a corporate governance framework that promotes accountability, responsibility and performance within the public sector is the responsibility of the line-managers (the chief executive officer (CEO) and the senior management team) of an organisation.

In chapter three committed and competent line-managers were regarded as the first prerequisite of performance measurement. The way in which financial management is practised depends on the commitment of senior management to develop financial management systems and expertise to support a performance management culture. The performance culture is one area where line-managers are held directly accountable for financial and operational performance.

In Chapter two committed and competent line-managers were indicated as the first category for effective financial management. The features for effective financial management were also discussed. Committed and competent line-managers include features of sound financial management, such as

- Accrual management;
- financial management being the responsibility of managers;

- financial advice being the responsibility of financial staff;
- professionally qualified financial staff;
- chief executives and other key staff that are on an outcomes based limited term contract that is supported by performance agreements;
- clearly defined responsibilities for the chief executive; and
- incentives to ensure the efficiency and risk management principles are to be followed.

In this chapter attention will be focused on the role of line-managers in provincial governments and the functions and responsibilities of the executive authority, the chief executive officer and chief financial officer. The training needs will also be addressed at the end of the chapter.

The following section deals with the role of line-managers in the provincial government sphere.

4.2 THE ROLES OF DIFFERENT LINE-MANAGERS IN PROVINCIAL GOVERNMENTS

Financial management should be the responsibility of executive managers/ heads of departments. These persons can only do this with the provision of high quality financial information and advice, which is the responsibility of professional financial managers.

Sections 27, 28, 30, 38 to 45 of the PFMA clarifies the roles of the heads of departments (CEOs or the accounting officers in terms of the PFMA) and the political head (also referred to as the 'executive authority' – either a Minister at national level or a Member of the Executive Council (MEC) at provincial level). The PFMA (section

44 (1)) also highlights the positions of other officials such as the Chief Financial Officer (CFO) whose main responsibility is to provide accurate, appropriate and meaningful financial information on which strategic financial decisions can be taken. The CFO should provide the CEO with the relevant information which the CEO can use for effective financial management. The final responsibility of financial management therefore lies with the CEO whilst the CFO is to provide the necessary financial information.

All officials of government departments have responsibilities. Shall (2000:22) referred to section 45 of the PFMA that prescribes the responsibilities of departmental officials by stating that: "An official in a department –

- must ensure that the system of financial management and internal control established for that department is carried out within the area of responsibility of that official;
- is responsible for the effective, efficient, economical and transparent use of financial resources within that official's area of responsibility; and
- must take effective and appropriate steps to prevent, within the official's area of responsibility, any unauthorised expenditure, irregular expenditure and fruitless and wasteful expenditure and any under-collection of revenue due."

In effect, this implies that each line-manager is responsible for the use of financial resources or contributions to a particular programme. In addition, because measurable objectives must be submitted for each main division (programme) within the department vote (section 27(4)), line-managers may also be held accountable for the outputs generated within that programme.

Corporate governance, as seen in chapter two, is an integral part of financial management and describes the overall management of affairs of an organisation. The Australian National Audit Office (MAB 1997:14) suggests that corporate

governance is generally understood to encompass authority, accountability, stewardship, leadership, direction and control. The author also identified the attributes of governance as appropriate legislative structures, clearly articulated ethical standards, internal accountability structures, external accountability and reporting structures, effective financial management structures and resource management structures. Effective financial management hinges on all these attributes of corporate governance and its importance in the public sector is therefore no different to that of the private sector (Lubbe 1997:49). The establishment or refinement of a corporate governance framework that promotes accountability, responsibility and performance within the public sector is the responsibility of the CEO and the senior management team (MAB 1997:42). Coopers and Lybrand (1995:39) supported this notion and stated that “where elements of significant good practice have been identified in government departments, this has tended to be where senior management has actively sought best practice as a facet of their leadership style.”

Within a performance management framework the role of both financial and line managers has to change dramatically. The empirical study showed that 93% of the respondents are of the opinion that management skills will have to change in future whilst 72% felt that leadership styles will also be influenced. Essentially, a new set of skills such as the ability to strategically integrate budgets with strategies and to implement accruals-based accounting and GAAP, is required by these managers (compare Shall 2000 :24).

From the above it is clear that three positions are important in financial management in the public sector, namely the political head, chief executive officer and the chief financial officer. The responsibilities of these positions will now be discussed. The training needs for financial staff are addressed towards the end of this chapter.

4.3 THE EXECUTIVE AUTHORITY

The executive authority, in relation to a constitutional institution consisting of a body of persons, means the chairperson of the constitutional institution (RSA National Treasury 2001:3). The executive authority includes the political head of a department on the national government sphere and for a provincial department it means the MEC of that department with his executive officials. The accounting officer or CEO reports various financial aspects to the political head that is the line-manager of the accounting officer (CEO) of a department. According to the PFMA the following should be reported by the accounting officer to the political head:

- Various financial and policy considerations (Section 38 (1));
- under-collection of revenue due, shortfalls in budgeted revenue and overspending of budgeted votes (Section 39 (2) (b));
- annual report of activities, annual financial statements and the report of the Auditor-General (Section 40(1)(d));
- within 15 days after month-end a monthly financial report, expected income and expenses for the rest of the year and material variances from budgeted figures and how these will be addressed (Section 40(4)(c));
- inability to comply with the accounting officers duties (Section 40(5)); and
- report and recommend any changes between main divisions within votes (Section 43(3)).

According to McCarthy (2003) the PFMA is not yet fully implemented in the Free State provincial government and therefore the fulfilment of the abovementioned duties could not be tested in this study. The study tested the involvement of the political head in the financial management of a department. Only 38% of the respondents are of the opinion that the political head should be involved in the financial management in provincial government departments. This low rating is perhaps because the CEO is in accordance with the PFMA responsible for financial

management in provincial government departments and not the political head. The executive authority, however, is responsible for policy choices and outcomes and will actively take part in the strategic planning process.

From the above discussion it is evident that the executive authority therefore forms an integral part of the financial management process. The executive authority is involved in the strategic planning process in order to identify the desired outcomes and outputs and needs to receive feedback from the accounting officer on a regular basis on the performance of a provincial government department as to the actual results and achievements.

In this section it was concluded that the responsibility of the executive authority is the formulating of policy and outcomes in order to provide guidelines for the strategic planning process. The chief executive is indeed involved in the financial management process. The next important officer who is identified by the PFMA is the accounting officer or the chief executive officer (CEO) of the department.

4.4 THE CHIEF EXECUTIVE OFFICER (CEO)

The chief executive officer/accounting officer implements the policy and achieves the outcomes by taking responsibility for delivering the outputs defined in the departmental budget. In this way, the PFMA empowers accounting officers by unambiguously conferring on them a clear set of responsibilities. The accounting officer prepares the departmental budget (specified in terms of measurable objectives) for the Minister or MEC to approve and present to the Legislature for voting. The accounting officer, therefore, is responsible for implementing and managing the budget within a performance measurement framework.

Sections 36 (1) and (2) of the PFMA states that each department must have an accounting officer, who also acts as the head of the department. This section of the

PFMA also refers to the accounting officer as the Chief Executive Officer (CEO). An extensive part of the PFMA deals with the duties of the accounting officer which makes the accounting officer an important line-manager in terms of the PFMA.

With the new expectations on government to operate more businesslike (see chapter two), the role of the accounting officer will be critical in steering and guiding the change process. It is the determination of top or senior management that will ensure that an organisation has the tools to achieve organisational performance. Chief Executive Officers do not need to know everything about financial management, but according to MAB (1998:42) the CEOs, however, do need to know what questions to ask to foster a financially astute culture throughout the organisation.

Financial management is therefore inter alia the responsibility of the CEO. The empirical study revealed that 90% of the respondents are of the opinion that financial management of a provincial department is the responsibility of the CEO. The other 10% might have felt wrongly that the financial officials have the responsibility.

The CEO is held accountable for the financial management within a provincial department. The Management Advisory Board of Australia (MAB) (1997:42) suggested that Chief Executive Officers must ensure the following prerequisites for effective financial management:

- A corporate planning process that includes financial planning in strategic and operating planning. These plans should link with performance plans for all the key operating activities with performance targets;
- monthly executive management reports that include financial and non-financial performance indicators which link directly to the Key Performance Indicators (KPIs). Reports should be performance-oriented and identify clearly the non-achievement of targets, who is responsible, what remedial action is proposed and by when;

- an integrated financial management information system that is the single source of data within an organisation;
- use of accrual information in all budgeting and management reporting;
- all outputs defined, cost and priced on an accrual basis;
- responsibilities for the delivery of outputs clearly articulated and understood;
- the appointment of a chief financial officer (CFO) who has professional accounting qualifications and who reports directly to the CEO;
- a large proportion of finance staff who have professional qualifications; and
- line-managers who are financially astute.

A CEO, therefore, must report on all financial aspects of the organisation. To assist CEOs in this endeavour the balanced scorecard that was discussed in chapter three, can be used as an effective tool to allow CEOs to focus on the performance of the organisation as a whole. It allows the CEO to view patterns across the organisation and observe where change action is required, or where areas need to be debated.

In terms of planning and budgeting, CEOs and other line-managers need to be able to define the objectives of their particular programme, which in turn will lead to defining the key activities, outputs and outcomes for service delivery. The CEOs need to ensure that lines of accountability are appropriate and match the required responsibilities and outcomes. The CEOs also need to be able to refine programme objectives and structures according to the feedback received from performance monitoring and evaluation. This monitoring and evaluation should take place on a regular basis to ensure a performance measurement culture within provincial government departments which is the main objective of this study.

The PFMA assigns specific responsibilities to accounting officers. The Act confers particular key responsibilities that are:

- The operation of basic financial management systems, including internal controls in departments and any entities they control (Section 38);

- to ensure that departments do not overspend their budgets (Section 39);
- to report on a monthly and annual basis, including the submission of annual financial statements two months after the end of the financial year (Section 40 (1); and
- and to publish annual reports in accordance with GRAP that will introduce performance reporting (Section 40 (3) (a)).

Accounting officers of provincial government departments who are negligent and make no effort to comply with these responsibilities will face strict disciplinary sanctions, including dismissal. Similar sanctions will apply to treasury and other officials.

As the responsibilities of CEOs increase, international experience suggests that rank and pay should be congruent. According to Shall (2000:25) this has resulted in the creation of posts such as Chief Financial Officers (CFOs) who will be responsible for the implementation of financial management of departments. In the next section the CFO will be discussed.

4.5 THE CHIEF FINANCIAL OFFICER (CFO)

The CFO within the provincial government sector context will play a pivotal role in that they provide accurate, timely and useful financial information that can be used in the financial decision-making process. The ability of the CFOs in the provincial governments has to be strengthened as they are currently not suitably qualified or do not have the necessary expertise to implement the requirements of the PFMA in particular with regard to GRAP and accrual accounting effectively. The empirical study showed that only one CFO in the Free State Province has a professional qualification and this will hamper the implementation of the GRAP due to a lack of expertise.

According to Du Randt (1999:11) the three “Rs” of financial officials – ‘reading, writing and arithmetic’ – are now longer enough. The three “Cs”- computing, critical thinking and the capacity for change should take the place of the three “Rs” so that CFOs are able to provide useful information for the decision-making process. The empirical study revealed the following importance ratings with regard to the attributes of the CFO:

Table 4 Attributes of the CFO

Attribute	Rating	Ranking
Professionally Qualified	92%	1
Critical thinker	92%	1
Flexible mind	88%	3
Financial analyst	86%	4
Good communicator	81%	5
Number Cruncher	53%	6

It is clear from the above table that the CFO of a provincial government department should not only be a number cruncher. He/she should at least be professionally qualified and a critical thinker with a flexible mind to adjust to the changing circumstances and to perform his/her duties in such a manner that relevant information is provided to enhance financial management. With regard to the experience and/or the ability of the CFO it is recommended that government organisations should seek to employ a CFO who is professionally qualified and is a full member of a recognised professional body, such as the South African Institute of Chartered Accountants. The requirements for membership of this Institute are a reliable measure with regard to appointments of a CFO as these members should have the necessary education and practical training. The other skills-based attributes,

such as relevant experience, critical thinker, good communicator and flexible mind should also be considered.

In the private sector, top management teams in modern corporations typically consist of the Chief Executive, Directors of major business divisions, the marketing director and the Chief Financial Officer (CFO). According to MAB (1997:43) the person with the financial responsibility is generally not included in the top management of public sector entities and is, in fact, well down the seniority line. It is evident, therefore, that the public sector is clearly out of line with the private sector and departments should include the CFOs in top management. The value-adding role of the CFO within the organisation is dependent on the seniority of the CFO within the organisational structure. Lack of seniority undermines the effectiveness of the information provided by the CFO (compare Visser 2000:299). It is recommended that government organisations should appoint CFOs, who has a direct reporting line to the CEO and should have the necessary seniority as an executive member of an organisation.

Nair (2000:26) is of the opinion that the complexity and diversity of an accounting officer's (CEO) responsibilities increases the need to rely on sound financial advice to ensure value for money in the delivery of services to the public. Almost all decisions have financial implications and it is therefore of paramount importance that sound financial decisions be taken in this regard. The Treasury Regulations in South Africa emphasise the need for the accounting officer to appoint a suitably qualified and competent CFO to assist with these strategic financial decisions in order to make sure that services are delivered in a cost effective manner (Nair 2000:26).

The CFO is also required to provide the required assistance to the accounting officer in discharging the duties under part 2 of chapter 5 of the PFMA with regard to financial responsibilities.

The Guide for Financial Officers, prepared by the RSA National Treasury (2000:27) supported the abovementioned and stated: "Government increasingly recognises the importance of financial staff. While the accounting officer (and indeed every line manager) is accountable for financial management, he or she must be able to rely on independent, professional advice to improve the quality of decision-making. Most private companies and a growing number of public entities appoint a CFO for this purpose." The importance of the CFO cannot be overemphasised. This is substantiated by the fact that 86% of the respondents in the public sector indicated that their department has a CFO employed.

Flowing from the aforementioned it is important to note the link between financial advice and service delivery. Every accounting officer should be aware of the costs of services. Without knowing the true costs of a service no decision, for example, can be taken to outsource a service as nothing is available to which the quoted price of the outsourced service can be compared.

The role of CFOs should furthermore be to support service delivery. The CFO should support CEOs in making decisions regarding the various options for service delivery by the provision of information on efficiency and effectiveness without dictating service delivery outputs. Peter Mitchell, the CFO of Nestle as quoted by MAB (1997:43), sees it as follows: "A lot is expected of CFOs today, but at the end of the day he or she is a co-pilot, not the pilot. The CEO is the pilot and the CFO is sitting there telling him or her the ramifications of landing on one engine as opposed to two. The two roles are quite distinct." As the CEO will be responsible for the financial management, the role of the CFO will be to give independent professional advice that will improve the quality of information for decision-makers within a provincial government department in order to maintain effective financial management.

In 1996, Korn Ferry as referred to by MAB (1997:43) surveyed CFOs in the top 300 Australian companies. The aim of the survey was to determine the attributes of the

modern CFO. While the survey was private-sector based, the results, as summarised below, reinforce the importance of the CFO within organisations:

“More than 54% of the respondents use the title CFO or financial director, reflecting the growing visibility of the role; 80% report directly to the CEO, in cases where this was not the case the CEO was usually off-shore; 96% have regular access to the CEO and 75% are in periodic contact with the board whilst 43% sit on the board themselves.” The MAB (1997:44) stated that a similar emphasis to the role of the CFO in the public sector was observed in the United States. West (1997:32) stated that the Board of Directors of a company would look to a CFO to:

- Understand the role, statutory and commercial law duties and general concerns of the directors;
- ensure timely and accurate flows of information to the Board;
- give early warning of potential threads or adverse conditions;
- provide, with the CFO, a strategic view of the organisation;
- identify, examine and propose processes to minimise organisational risks;
- ensure transparent and effective audit processes;
- review information being transmitted to the market; and
- constantly review the quality of the information and processes involved with the reporting to the Board.

The deduction, therefore, can be made that although the abovementioned examples identified the role of the CFO in the private sector, the issues are directly applicable to the role of the CFO in the public sector. The MAB (1997:45) referred to Jeff Henley, Executive Vice President and CFO of Oracle Corporation (USA), in addressing a conference of CFOs: “Your goal should be to make sure that finance is viewed as part of an integrated system that has links outside the traditional financial walls and outside the boundaries of the organisation itself. The point is to be able to provide decision support, not just accounting data, to those who need it, when they need it and in the format they need it. Finance should ultimately be viewed as the steward

of the organisation's overall management and decision-making process." The message of Henley clearly emphasised that CFOs should minimise the number crunching and have to maximise value-adding analysis by providing decision-making information. This can also be applicable to the public sector.

However, apart from maximising the value-adding role of CFOs in the public sector, it is furthermore necessary for the financial staff currently employed in the public sector to undergo a mind shift to revert from the old cash system that was used for more than 25 years to a fully integrated accruals system.

Bearing in mind the fact that the requirements of the PFMA are to be implemented with current staff members that do not necessarily have the necessary experience and expertise and that need to undergo a paradigm shift from old financial management systems and processes, it is important to address the problem via extensive training programmes. Training will play an important role in this regard. In the next section subsequent attention will be paid to the training needs of financial officials.

4.6 TRAINING NEEDS FOR FINANCIAL OFFICIALS IN PROVINCIAL GOVERNMENTS

Staff members are important assets in any organisation and should be maintained just as other tangible assets (compare Scott-Paul 2001:16). The staff members should be trained or reallocated if necessary. The successful implementation of the provisions of the PFMA will largely be determined by the skills and competences that a public sector official in the different financial management and accounting occupational categories possess. This in return will be determined by appropriate training.

Training will enhance performance and accountability. The drive for increased accountability in human services in the United States has put enormous pressure on government to develop performance measurement systems (Poole et al. 2000:15). These performance measurement systems for staff members will not reap any benefits without the necessary training to develop the skills of staff in order to perform better. If the public sector in South Africa wants to introduce a performance measurement system for its employees the need for training is an important prerequisite.

The National Treasury (2000:5) stated that the implementation of the PFMA will be a "*collective learning experience*" for all involved, as practices that have been in place for many years will be challenged, re-thought and modified. The more qualitative changes, such as Generally Recognised Accounting Practice (GRAP), will be phased in over several years. However, it was noted that significant changes in financial management systems were necessary in the nearby future. Accounting officers, therefore, will need to ensure that the essential systems for effective implementation are in place. Preparations will include employing appropriately qualified and experienced chief financial officers (CFOs) and accountants, setting up effective internal controls, constituting an audit committee and ensuring that the in-year management requirements are met.

The empirical study revealed that only 41% of the financial staff in the Free State Provincial Government has accounting qualifications. From the study it became apparent that financial staff has a lack of experience, knowledge and skills in respect of financial attributes. The study also revealed that financial staff has a negative attitude towards reform. This situation needs redress as it will be difficult, for example to implement a new system of accruals base accounting in provincial governments where such attitudes prevail.

Most of the support financial staff does not have the necessary education and financial background. Support staff need to be trained and if serious knowledge and experience gaps are evident, qualified people must be recruited. If current staff have serious knowledge and experience gaps they could impede the financial management reform process. It was suggested by the respondents in the empirical study that financially unsuitable staff should be reallocated to other departments in order to recruit qualified people. However, the recruitment of suitably qualified finance staff will be costly for government as properly qualified financial people are earning huge salary packages in the private sector. New staff that is recruited from the private sector, should also be trained as they should get familiar with the public sector environment.

Feinstein (1999:4) highlighted the training needs by stating that at the budget hearings held in Parliament in 1999 at least two submissions to the Finance Committee stated that financial training in the public sector was the single most important issue facing the new South Africa. It is evident that training must be presented to the above-mentioned groups of officials to ensure that they will in future be able to comply with the requirements of the accrual accounting systems and understand the new reporting formats (compare Visser 2000:301). From the empirical study it became clear that the training of financial staff is still high on the priority list of provincial governments.

Successful financial management is the result of a collective and conscious effort from everybody in the organisation, as guided by a technically trained and proficient CFO who is objective and performs his/her duties with due professional care. According to Van der Linde (1999:19) it is recognised that financial managers in the public sector must be trained technically and be proficient in at least the following subject areas of financial management:

- Strategic management;
- workflow design;

- performance measurement;
- financial accounting;
- management accounting;
- internal control;
- internal and external audit;
- information technology;
- economy;
- negotiation skills;
- communication and other management skills; and
- analytical skills.

Neither in-house nor tertiary training programmes have given adequate attention to the above subject areas within the public sector context. The empirical study also revealed the lack of training in these areas as a serious shortcoming. The reform of financial management, as supported by the PFMA will require a reformed financial education and training system. Universities and technikons therefore need to address these issues developing their public administration and management training courses. Until recently not much demand for these types of skills have been identified hence little effort was taken to provide them.

It is not only the financial managers that need training, but also the non-financial line-managers, such as the heads of departments (CEOs). As indicated earlier, the CEOs take responsibility and are accountable for the funds allocated to their departments. It is important, therefore, that CEOs are able to understand the financial information that they have at their disposal.

If the gap of skilled financial and non-financial line-managers is not filled, the implementation process of an integrated financial management system will be seriously hindered. Johnson (2000:81) reported that more Australian agencies are

employing personnel with strong accounting expertise, including chief financial officers, as members of executive teams.

As the necessary skills of public sector managers begin to emulate those of private sector managers, especially when generally recognised accounting practices such as accrual accounting are introduced increased mobility between the private and public sectors will take place. Thus, if both the public and private sectors have the same accounting systems, it will be easier for private sector accountants to be recruited by the public sector and visa versa.

The requirements of the PFMA demand that all managers assess their current skills complement and compare it to what is necessary in order to ensure effective and efficient financial management of provincial government departments. It is imperative that managers make plans to acquire these skills.

4.7 CONCLUSION

Committed and competent managers are the first of the three prerequisites for effective financial management the identification. The human factor in effective financial management cannot be over-emphasised. People are the most important and most expensive asset to an organisation. The human capital and the way it is developed and deployed will determine how successful the challenges facing the organisation will be met.

Financial management in provincial governments should be the responsibility of managers (CEOs, Heads of Departments or Accounting Officers) and not the responsibility of CFOs. Ten per cent (10%) of the respondents still think that financial management is not the responsibility of the CEO, but that of the CFO. The CFO should only fulfil a support role to provide financial information, guidance and advice to the Accounting Officers. The CFO should be part of the top management team

and should professionally be qualified and registered with a professional body. It was found that only one CFO in the Free State Provincial Government is professionally qualified; this might hamper the implementation of the GRAP due to a lack of expertise. Other finance staff should have a positive attitude towards financial management and be inclined in a financial manner. This study also indicated that only 41% of financial staff in provincial government departments are financially astute and have accounting qualifications.

The training of current finance officials should be of the highest priority in provincial governments. The study revealed a serious lack of skills, knowledge and expertise among the finance staff of Free State Government Departments together with a negative attitude towards change. Programmes at universities and technicons should be developed to educate the CEOs and CFOs of the future.

The recruitment of suitably qualified CFOs should be of the highest priority. Salary scales in Provincial Governments should be market related and need to be sufficient to attract and retain accounting staff of the right calibre. A best-man-for-the-job policy should be conducted and affirmative action policies should not be taken into account.

The features of good corporate governance cannot be applied in provincial governments without committed and competent managers. Sound recruitment policies, acceptable conditions of employment and training programmes can contribute to a competent finance staff force. The quality of financial management in public sector entities is directly related to the ability to obtain and retain qualified financial managers, accountants and CEOs.

The first prerequisite of performance measurement was discussed in this chapter. The second prerequisite outcomes-based budgeting will be addressed in the next chapter.

CHAPTER 5

PREREQUISITE FOR PERFORMANCE MEASUREMENT: PART 2

OUTCOMES-BASED BUDGETING

5.1 INTRODUCTION

In chapter four the first prerequisite for performance measurement was discussed, namely committed and competent line-managers. The second prerequisite is outcomes-based budgeting and will be addressed in this chapter.

Outcomes-based budgeting includes features of sound financial management, as discussed in chapter two, such as professional financial contribution to strategic and operational planning; clearly defined objectives and specified outputs and accruals-based budgeting. After the strategic outcomes of an organisation are identified the financial contribution into strategic and operational activities will be logical. Strategic planning is the starting point of outcomes-based budgeting. Strategic planning deals with the interpretation of stakeholder requirements and expectations and the formulation of plans to meet these requirements. It is all about focusing on outcomes and outputs. Without identifying the outcomes in the strategic planning process performance measurement will be of no use as no benchmark is identified.

Outcomes-based budgeting, therefore, means to budget with the desired outcomes in mind that form the basis of performance measurement as actual outputs are compared with the anticipated outputs.

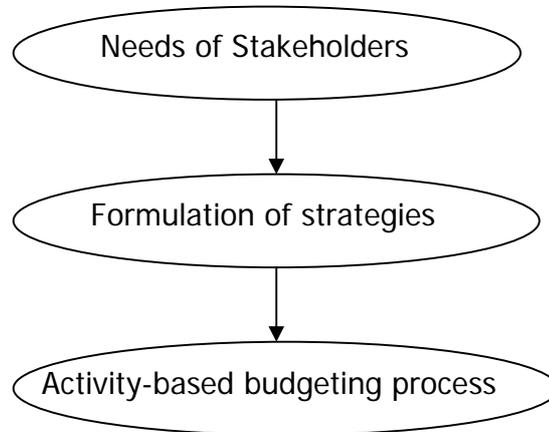
In this chapter the nature and various types of budgets will briefly be discussed while the shortcomings of the current budgetary systems in provincial governments are also highlighted. The chapter will also address the key factors of an effective budgetary system. The harmony between accounting and budgetary systems and the integration thereof are described as well as activity-based budgeting, costing and management. Finally, the process for effective budgeting is discussed that will include the various steps of the budgetary process.

5.2 NATURE OF BUDGETS

Garrison and Noreen (2000:378) defined a budget as a detailed plan for the acquisition and use of financial and other resources over a specified period. It represents a plan for the future expressed in formal quantitative terms. The act of preparing a budget is called budgeting and the use of budgets to control the activities of an organisation is known as budgetary control.

Planning involves the development of objectives and preparation of budgets to achieve those objectives while control involves the steps taken by management to increase the likelihood that objectives determined at the planning stage are attained. A sound budgeting system must provide for both planning and control.

In the planning process objectives are identified that satisfy the needs of the stakeholders. In order to satisfy the needs of the stakeholders outcomes should be identified as well as the strategies to be implemented to satisfy these needs. These strategies should eventually be linked with the planning of processes and activities. Glad and Becker (1994:158) used the following diagram to illustrate this linkage:

Diagram 9 Outcomes-based budgeting linked with strategic planning

(Glad & Becker 1994:158)

The strategic analysis of the outcomes that are required by the stakeholders is an important element of the budgeting process as this provides a link with the strategic planning process. The above process also refers to budgeting by activities (see third step above) which forms the basis of activity-based budgeting that will be discussed in paragraph 5.8.3. The formulation of outcome objectives, output performance measures and operational plans are part and parcel of strategic planning and budgeting.

Quantifiable planning without effective control is time wasted. On the other hand, unless plans are laid down in advance, no objectives exist toward which control can be directed and performance measurement should be impossible.

Budgeting is an essential element of the financial planning, control and performance evaluation processes of public sector entities. By its nature it is a means of allocating resources to achieving the objectives of a public sector entity, and a management tool for planning, as well as a means of controlling funds to ensure that the stated objectives can be met (IFAC 2001:272).

The legislative authority in provincial governments is usually responsible to approve a budget or financial plan within the overall approved level of expenditure to provide authorisation for the acquisition and use of financial resources. The authority is also responsible for overseeing and monitoring the implementation of the approved budget or financial plan (Reddy *et al.* 2003:68).

Budget reforms worldwide have replaced procedural accountability with accountability for results. In other words, instead of ensuring only that the correct authorisation procedures are being followed and thereby accounting for each Rand spent, emphasis is now also being placed on the value-for-money achieved by such spending (compare Shall 2000:21 and Kluvers 1999:72). The value-for-money concept means that the outcome and outputs of services that are delivered must justify the expenditure. Fruitless expenditure is to be highlighted and eliminated as no value (outputs) for expenditure is incurred.

A number of budgetary methods exist that can be used in provincial government departments, each with an explicitly different focus. In the next section the different types of budgets will be discussed.

5.3 TYPES OF BUDGETS USED IN PROVINCIAL GOVERNMENTS

Kluvers (1999:69) stated that a budget in the public sector is a key element in planning and performance measurement and is a major vehicle to allocate resources. The author continues by stating that the type of budget that an organisation uses can have an influence on budgeting systems and identifies four main budget types, namely:

- Line-item budgeting being the traditional form of budgeting in which a line exist for each of the resources an organisation intends to use in a specific period. Its major focus is on inputs;

- performance budgeting focuses on the unit cost of activities and is a precursor of programme budgeting;
- zero-based budgeting emphasises the justification of all expenditure including an examination of the effects on performance of a change in expenditure; and
- programme budgeting identifies the objectives of an organisation and the resources required to achieve those objectives; importance is placed on the intended outcomes of the proposed expenditure and multi-period perspective is adopted (compare Visser *et al.* 2002:79).

The respondents in the empirical study indicated that sometimes more than one budgetary method is used. The empirical study revealed the following types of budgets being used in provincial government departments:

Table 5 Types of Budgets used in provincial governments

Type	Percentage of occurrence
Line-item budgeting	67%
Programme budgeting	87%
Zero-based budgeting	53%
Activity-based budgeting	53%

From table 5 it is clear that programme and line-item budgeting is the most frequently used in provincial government departments. Programme budgeting is closely related to activity-based budgeting and confusion could have occurred in filling in the questionnaire. It is doubtful whether departments have the necessary costing systems in place to implement activity-based budgeting.

Line-item budgeting does not incorporate planning or the aim to meet objectives, but is primarily concerned with controlling and confining the budgetary process to setting

aggregate spending limits. Rayburn (1996:338) referred to this budget as an appropriation budget where the spending limits are strongly emphasised. Due to the appropriation budget concept, managers often focus more on spending resources than on obtaining results. Unfortunately, this budgeting concept encourages managers to think of incremental increases in budget amounts rather than to consider the services offered or rendered. Rayburn (1996:338) continued by saying that a cost/benefit relationship is often not the basis of performance evaluation.

Zero-based budgeting is an attempt to overcome the shortcomings of incrementalism of line-item budgeting. Zero-based budgeting calls for a re-evaluation of activities and their costs on a regular and rotating basis (compare Drury 2001:305). The focus is also on the objectives of an organisation. Managers must justify their entire budgets and not only the changes proposed for the budget year. No (zero) money will be spent on each activity until they can justify an allocation for expenditure - hence the term "zero base".

Performance budgeting and programme budgeting are closely related and seems strategically to be the best methods of budgeting. Rayburn (1996:338) and Visser et al. (2002:80) indicated that programme budgeting includes performance budgeting that involves attempts to describe programme objectives and alternative measures to meet them. Objectives are matched with the cost of achieving them. The features of programme budgeting is that it consist of functions (broad groupings of objectives), programmes (broad categories within the scope of functions) and activities (manageable portions of a programme). Activity-based budgeting, therefore, is closely linked with programme budgeting and will be discussed and promoted in this chapter.

It is apparent from the abovementioned that a definite link should exist between planning and control. During the strategic planning phase the outcomes and strategies are to be identified as well as the required output targets and how it

should be measured. Wang (2000:104) stated that in budget preparation, central government could use performance indicators in budget instructions to demonstrate desirable performance levels. The identification of performance indicators is a critical element in the performance measurement framework that forms the main objective of this study.

The current budgetary systems that are in use in the public sector can not fulfill the demands of the requirements of the PFMA and the New Public Management system. The respondents in the empirical study were asked to rate the budgetary system in provincial government departments and gave an effective rating of 59%. Various shortcomings of budgetary systems of provincial government departments were highlighted in the study and these will subsequently be discussed.

5.4 SHORTCOMINGS OF CURRENT BUDGETING SYSTEMS APPLIED IN PROVINCIAL GOVERNMENTS

According to the IFAC (2001:par. 279) The World Bank Publication, "Financial Accounting Reporting and Auditing Handbook" the budget problems in developing countries relate to:

- Lack of appropriate feedback systems;
- failure to integrate budgeting with accounting and cash management functions;
- lack of comprehensive coverage, that is certain programmes/agencies may be excluded from the budget;
- focus on one year rather than multi-year;
- classifications or budget categories not fully useful for expenditure planning and control;
- lack of focus on goals and programmes;

- lack of clarity and accuracy in defining recurrent and development expenditures; and
- over-emphasis on sophisticated concepts beyond realistic capacity.

Apart from the above the empirical study also revealed the following shortcomings of budgetary systems used in provincial government departments:

- Strategies and budgets are not aligned;
- costing skills of staff are lacking;
- lack of qualified and experienced staff;
- information systems are not in place;
- budgets are not zero-based, but rather make use of the line-item budgeting method;
- inadequate monitoring and measurement;
- no communication with stakeholders to determine needs; and
- capital budgets (for long-term assets) are not separate and are still part of operating expenditure (not on an accruals-basis).

It is clear from the above that budgetary systems in provincial government departments are not in line with contemporary budgetary strategies. Performance measurement, therefore, will be impossible as desired outcomes and outputs are not linked to the budgetary process.

The Guide for Accounting Officers as prepared by the South African National Treasury (2000:3) indicated that in the past, financial processes were controlled by centrally prescribed bureaucratic rules that allowed little scope for managerial discretion, and even mundane issues had to be referred for 'Treasury approval'. This was, in fact, financial administration, regulating how money was used to 'buy' inputs and diverting attention from the delivery of the outputs that the inputs were intended to achieve. This approach did not clearly define responsibilities, and resulted in poor

accountability and value-for-money. The incremental (one-year) budgetary system undermined planning and the prioritisation of programmes. Accounting officers adopted a passive approach to their budgets during the financial year, and did little to avoid overspending or underspending. This was compounded by delays in producing financial information that was often only available well after the end of the financial year (compare Fakie 1999:13, Nair 2000:26 and Visser *et al.* 2002:79).

Effective budgetary systems used in provincial government departments should address the above shortcomings. In the next section the key factors of effective budgetary systems will be discussed.

5.5 THE KEY FACTORS OF EFFECTIVE BUDGETING SYSTEMS

The United Nations as summarised by IFAC (2001:75) indicated some of the key factors that contribute to making the budgeting process effective in practice. These factors are outlined hereunder:

Table 6 Key factors of effective budgeting systems

Transparency	<ul style="list-style-type: none"> • The budget documents provide a clear link between objectives and expenditures; • all participants in the budget process are clear about their roles and responsibilities; • simple, well documented procedures; • well-defined basis of budgeting e.g. incremental, zero-based; and • departmental/entity targets and resources allocated, clearly indicated and explained.
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Management	<ul style="list-style-type: none"> • Effective budgeting involves more than simply preparing annual budgets; the management and monitoring of the budget is equally important with an emphasis on results achieved.
Decentralisation	<ul style="list-style-type: none"> • It is potentially inefficient and may undermine the budget system for all decisions to be made at the centres.
Co-ordination and co-operation	<ul style="list-style-type: none"> • All those involved in the budget process are required to ensure links between recurrent and development budgets and the processes in the financial management system.
Integration	<ul style="list-style-type: none"> • The incorporation of recurrent and development projects: the recurrent costs arising from the development projects need to be built into recurrent expenditure planning and trade-offs between recurrent and development expenditure considered for sustainability.
Flexibility	<ul style="list-style-type: none"> • The system allows responses to changes circumstances: these responses are built into the system, so that implications of any changes are sufficiently analysed and still fit within the overall objectives and priorities of the public sector entity.
Discipline	<ul style="list-style-type: none"> • Although the system provides flexibility, effective control over expenditures is evident; • any changes to the budget are carefully analysed and justified;

	<ul style="list-style-type: none"> • only limited use of supplementary estimates; and • penalties for breach of rules and regulations.
Link to Medium Term Expenditure Framework (MTEF)	<ul style="list-style-type: none"> • Link between the resource framework of the MTEF and the annual budget; and • link between the policies and priorities of the MTEF and the budget allocations.
Accountability and credibility	<ul style="list-style-type: none"> • Governing body involvement: good links between the governing body and the executive; • involvement of accountability of senior managers in all stages of the process; • if the executive do not believe that they will be held to their ceilings, or if they can easily by-pass normal procedures, the whole process of budgeting can be undermined; and • budgets are reliably close to actual outcome.
Comprehensive	<ul style="list-style-type: none"> • The budget process and documents need to include all revenues and expenses, including aid funds; the budget also contains information on expenses of the previous and current year.
Performance measurement/ reporting	<ul style="list-style-type: none"> • Measuring the impact of the budget by means of output performance measurements for recurrent and development expenses.

(IFAC 2001:75)

The above key factors also address the shortcomings listed in the previous paragraphs. Shortcomings such as the lack of integration with strategic plans and not to plan for more than one year will be resolved if these features are applied in provincial government departments.

From the key factors above a clear line can be drawn between budgetary control and the principles of corporate governance that were discussed in chapter two. The features of openness and accountability and to a lesser extent integrity are apparent from the list above. Under openness one can include all the features under transparency and discipline. Under accountability one can include categories such as management, co-ordination, integration, flexibility, comprehensive and performance measurement and under integrity one can link categories such as credibility and discipline.

In the empirical study the above features were tested for their importance. The respondents gave the following importance ratings to the above features:

Table 7 Importance ratings of features for effective budgeting

Feature	Importance rating
Transparency	83%
Management and monitoring of the budget	96%
Decentralisation	74%
Co-ordination and co-operation	81%
Integration of recurrent and development budgets	78%
Flexibility when circumstances change	83%
Discipline	91%
Link to medium-term expenditure framework	84%
Accountability and credibility	94%
Comprehensive	85%
Performance measurement/reporting	92%

The importance of accountability in the budgetary system can be observed in Table 7. All the features with a rating of 90% or higher can be linked to the accountability principle of corporate governance. The accountability principle and performance measurement go hand in hand and harmonise with the objectives of this study as indicated in chapter one, paragraph 1.6.

The above features of budgeting cannot be applied by provincial government departments if the budgetary system cannot be supported by a uniform accounting and costing system. The following section explains the importance of an integrated accounting system.

5.6 THE INTEGRATION OF BUDGETING AND ACCOUNTING SYSTEMS

One of the key factors, as indicated in the previous paragraphs, is the integration of systems. Drury (2001:326) indicated that budgeting needs are to be integrated with accounting systems to be effective. If a similar basis of accounting is adopted for budgeting purposes and financial reporting, it will provide a framework of accounting information to present a more rational basis for planning and controlling expenditure and for decisions about its financing.

The IFAC (2001:par. 278) stated that regular monitoring of accounting results against the budget is vital (compare Wang 2000:102). The revenues or expenditures reported against budgets need to be reliable and readily available for discussion and management action, and projections are revised where necessary. The budget and accounting systems, therefore, should be in total harmony. Du Randt (1999:12) is of the opinion that an effective cost accounting system should be in place in order to produce the actual expenditure accurately. Without accurate actual information performance measurement and control will be impossible in provincial government departments.

If accrual accounting is adopted for financial and cost accounting purposes then the budgets should also be on an accruals basis. One must also bear in mind that budgets that are prepared on an accruals basis will not reflect cash in- and out-flows. Where the accounting system is based on an accruals basis of accounting, cash flow budgeting will form an essential element of effective cash management and therefore a forecast of the timing of cash inflows and outflows would always be needed.

This paragraph explained the importance of a cost and financial accounting system that should fully be integrated with the budgetary systems. In the following section this integration will be taken one step further and will highlight the inter-relationship

between the preparing of budgets on an activity-basis and an activity-based costing system.

5.7 THE INTER-RELATIONSHIP OF ACTIVITY-BASED BUDGETING, COSTING AND MANAGEMENT

In paragraph 5.3 above, programme budgeting was regarded as the best method of budgeting. Programmes consist of broad categories within the scope of specific functions. These programmes in turn can then be divided into various numbers of activities. Seeing that activity-based budgeting is based on determining expected costs of activities it can be deduced that activity-based budgeting are based on the same principles as programme budgeting.

Activity-based budgeting is based on the fundamentals of activity-based costing that is a methodology that measures cost and performance of activities, resources and cost objects. Everything is measured on an accruals basis and not on a cash basis. Resources are assigned to activities and then activities are assigned to cost objects based on the use or consumption of the relevant activities. Activity-based costing recognises the causal relationships of cost drivers to activities. According to the MAB (1997:76) the activity-based costing model is one of the most significant developments in cost accounting in the past 60 years. This may also be of benefit to provincial government departments.

Activity-based management focuses on the management of activities as a route to improve value received by stakeholders and includes cost driver analysis, activity analyses and performance measurement. Activity-based management draws on activity-based costing as its major source of information. According to Glad and Becker (1994:157) activity-based budgeting, therefore, is the logical progression from activity-based costing and management.

The preparing of budgets by means of the analysis of activities was highlighted in these aforementioned paragraphs. In the following section the process of activity-based budgeting will be discussed in more detail.

5.8 THE PROCESS OF EFFECTIVE ACTIVITY-BASED BUDGETING

A few steps exist in a sound budgeting process: Firstly, the identification of outcomes and objectives; secondly, the identification of activities within programmes designed to meet the objectives; thirdly, the identification of desired outputs and performance measures (the use of the balanced scorecard is promoted in paragraph 3.7 in chapter three); and fourthly, the preparation of these budgets by costing the activities within the programmes in financial terms. As was previously discussed programme budgeting harmonises closely with activity-based budgeting and should be narrowly linked with an integral activity-based costing system.

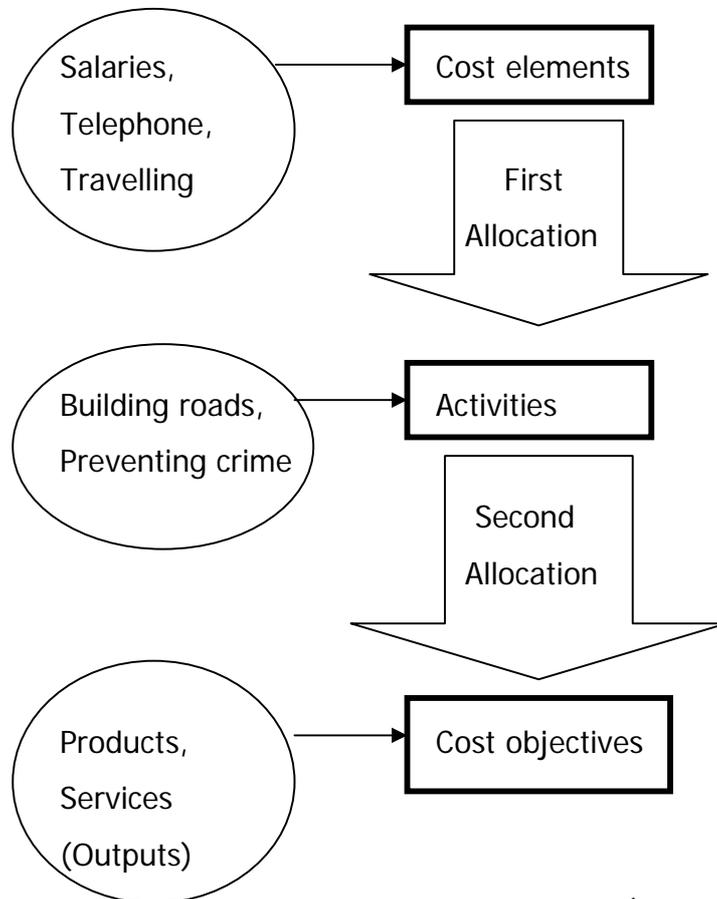
An extension of the balanced scorecard that was discussed in chapter three, sees it integrated into the overall strategic management system of an organisation. The balance scorecard should be used as a base to identify the most important objectives and identifies the critical initiatives to achieve these objectives. These objectives should be translated in financial terms by allocating financial resources towards these objectives. This process must define all contributing activities, understand how the activities generate costs, and then determine the level of cost each output consumes. This process extends the use of activity-based costing principles for budgeting to result in activity-based budgeting.

Hongren et al. (1999:197) stated that activity-based budgeting focuses on the cost of activities necessary to produce and sell products and services. In a service organisation the objectives can be divided into activities. These activities should be budgeted and cost by using activity-based budgeting and will be discussed in the next section.

5.8.1 Principles of activity-based budgeting

According to Glad and Becker (1994:157) the fundamental activity-based costing principles and methods provide a superb basis for the budgeting process. The details of activity-based costing will be discussed in paragraph 5.8.2. As it is necessary to discuss the budgeting principles (which should be based on an integrated system) it is important to give a brief outline of what activity-based budgeting entails.

Activity-based budgeting is primarily an accurate cost allocation system. It measures cost by using two allocation levels (see Diagram 10 below). Activity-based costing focuses on activities as fundamental cost objects. An activity is an event, task or unit of work with a specified purpose. Activity-based costing uses the cost of these activities as the basis for assigning costs to products, services or customers (Hongren et al. 1999:17). The costs of activities that are needed to provide services are used as a basis for assigning costs to outputs. The two allocation levels are illustrated in Diagram 10 below:

Diagram 10 Allocation of costs using activity-based costing

(Hongren et al. 1999:17)

From the above diagram it is clear that the allocation of cost has a logical flow. In the budgeting process the identification of activities and the budgeted cost thereof are of utmost importance. An activity-based budgeting system comprises the same principles as activity-based costing because the expected costs of outputs should be budgeted for and estimated by using the same principles used in activity-based costing that will be discussed in the next section.

5.8.2 Principles of activity-based costing (ABC)

One costing method that emerged in the 1980s first in manufacturing industries, but more recently in service industries, is Activity-Based Costing (ABC). This model is one of the most significant developments in cost accounting and deals with an accurate method of cost allocation to various products and services.

Apart from acquitting the external need to cost outputs, access to more detailed cost information is significant for the management of organisations and should be examined in more detail. The understanding of the component processes or activities that are needed in the production of goods or the delivery of services, are fundamental to effective management. Without this operational knowledge, managers will not be able to improve product quality, lower costs, or complete a greater range of services (compare Drury 2001:174).

Best practice costing systems have therefore been developed accepting activity-based costing as a profound costing system. This system defines all contributing activities, understand how the activities generate costs, and then determine the level of cost each output consumes. According to the MAB (1997:76) best practice costing systems therefore provide information focused on answering the “why” and ‘how’ questions of financial management rather than exclusively the ‘what’. These systems provide managers with information that adds to their ability to know:

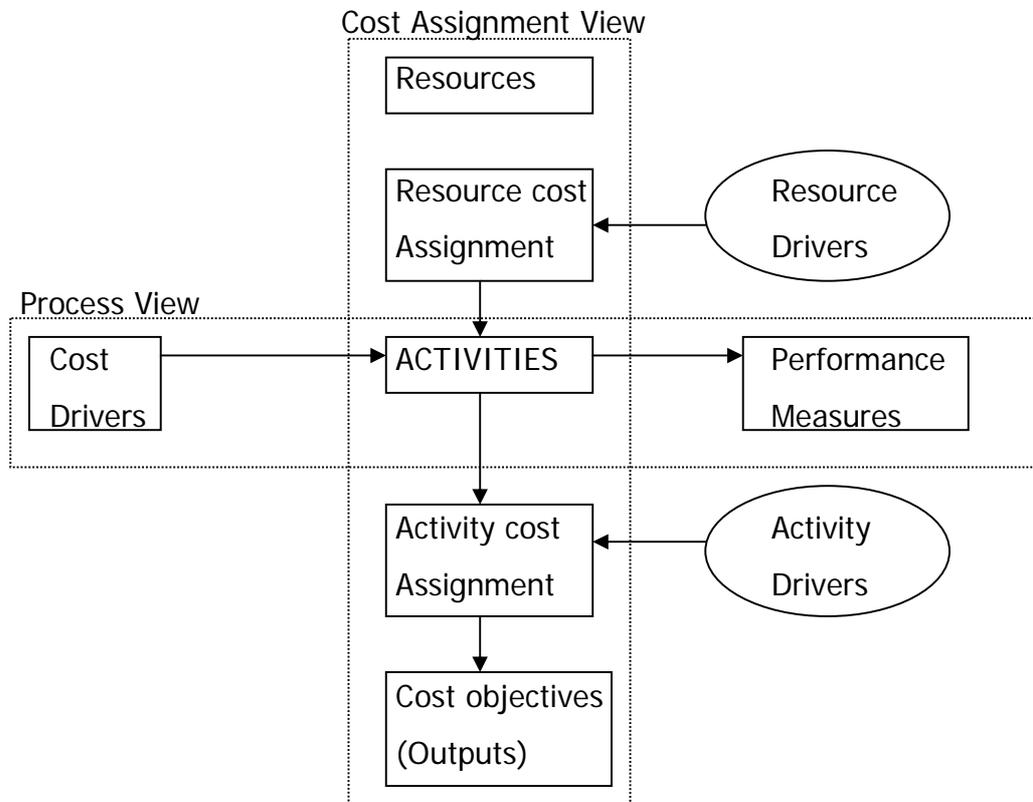
- How, and which processes and activities contribute to the production outputs;
- which activities add value to the production of outputs and which just add cost;
- what resources contribute directly to an activity or an output; and
- why and how, non-production costs contribute to the cost of outputs.

ABC is based on a premise that processes and activities within the organisation add value to outputs and that these activities consume resources. It is a method that

estimates output costs by focusing on what factors cause costs to be incurred. Thus, to reduce costs and/or increase value, activities rather than the outputs must be managed. By identifying the causal relationship between costs and activities, ABC has taken a significant step towards reliably linking output volume and total cost. This link is crucial for an organisation wishing to determine future costs based on the estimated or budgeted volume of activities. According to Drury (2001:174) organisations with a demand-driven output find this model useful for budget estimation.

ABC furthermore has a clear objective of adding value to the management of resources in an organisation. Implementation requires a multi-discipline approach that analyses all of the activities that contribute to the output from the organisation. This analysis identifies those activities that add value to the output and those that only add cost.

Producing better internal management information has the additional effect of increasing the quality of data on output costs to external bodies. Diagram 11 shows a two-dimensional model of the uses of activity analysis:

Diagram 11 Dual role of ABC in costing and cost management

(MAB 1997:77)

The Process View uses a detailed activity analysis to understand process improvement. The Cost Assignment View looks at aggregated activity data used for cost allocation to outputs and is therefore applicable to the public sector.

The empirical study revealed that it is possible to apply ABC in provincial government departments. Eighty-eight per cent (88%) of the public sector respondents are of the opinion that programmes can be divided in activities and 81% felt because of this, that ABC can be implemented in provincial government departments.

The ABC system requires the definition of those actions (processes) that result in resources being consumed (resource drivers) and those activities that are used to allocate costs to outputs. With this information, managers are in a position to make informed decisions on resource usage.

The MAB (1997:77) used a simple example to distinguish a resource driver and an activity driver in the purchasing function. The number of Purchase Orders (POs) processed for each client area is a relevant measure (activity driver) to allocate the unit costs to internal clients and/or outputs. However, it is the calling of a client to clarify PO details that is the main reason for cost increases (resource driver). This distinction is an important factor in the analysis of costs.

Generally, overheads and internal service costs are not recorded directly against outputs. Therefore, a separate operation is required to estimate the share of these costs attributed to each output – that is, to find the activity driver for cost allocations (compare Folk et al. 2002:122). The allocation of overheads to specific outputs can be achieved in a variety of ways (see diagram 12 below).

Determining the basis of cost allocations should be a collaborative exercise, using the experience of relevant line managers and accountants to identify (Albrecht et al. 2002:354):

- The principal actions that cause the total costs in the area to rise - to assist in managing the costs of the area; and
- what activity measures are already available, or easily made available;- to make the allocation process transparent.

The allocation of costs to programmes, functions or activities should be based on the actual usage of resources. Resource accounting (to allocate cost to services based on usage on an accruals-basis) is a tool to accommodate resource allocations and is a method of distributing internal support service costs to internal client areas (internal

functions) based on actual usage (compare Drury 2001:170). This method employs a formal system to record the usage of a service accurately, apply a charge for the service and bill each internal client area on a regular basis. The service charge must then be managed like all other controllable costs incurred by each client area. Resource accounting provides an accurate method of recording resource usage patterns but it can be expensive to develop the necessary support systems. The MAB (1997:77) is of opinion that resource accounting would not be implemented unless

- the service being charged for is crucial to the production of the outputs of the agency;
- the service cost is material to the agency;
- the estimated savings or improvements to quality outweigh the cost of developing and maintaining a system; and
- the data used to measure usage is generated at little cost, automatically and objectively.

Thus, costs that are not material and that cannot easily be linked to cost objectives, should not be allocated by means of resource accounting (Drury 2001:171). The most significant direct expense in delivering goods and rendering services, whether for internal or external consumption, is staff costs. Therefore, attributing staff costs based on a time recording method (by client or activity) is one of the most relevant bases available (compare Folk 2002:128).

The issue of staff recording their time by activity or job has been a contentious one (MAB 1997:79). Most problems appear to centre on fears that the information will be used as a performance measure of individual staff members. The Centre for Professional Development in Australia as quoted by the MAB (1997:78) reacted as follows to this fear: "Be assured that time recording of staff is only useful in allocating effort to client areas. It is unreliable and unproductive to use it for any other purpose." Once the connection between time recording and individual monitoring is

removed, the practice is generally accepted as being an essential tool for billing clients and/or cost allocation. Most professional service organisations (for example, legal, accounting, engineering) accept staff recording their time as standard practice.

Rather than collecting time usage information continuously, an alternative is to use sampling techniques. Cost allocations can be based on a sampling study of staff time to analyse activities over a representative period. The information is then used as a base to estimate cost allocation to activities. If costs (especially staff costs) cannot be allocated to activities on a reasonable basis, ABC will not be effective.

The development of systems to supply detailed cost information at a level that is relevant to and used by managers has proven to be an effective method to measure the costs of the outputs and hence also the performance (Folk 2002:134). Benefits from the use of detailed costing information include better informed decisions in provincial government departments.

The following diagram illustrates the basis of activity-based costing:

Diagram 12 Illustration of activity-based costing**Resource allocation**

	Secondary Processes		Primary processes		
	General Management	Finance & Admin	Procurement	Building	Inspection
Cost elements	R 100 000	R200 000	R100 000	R750 000	R45 000
Allocate Secondary processes	(60 000)	40 000	5 000		15 000
		(210 000)	180 000	20 000	10 000
			<u>R285 000</u>	<u>R770 000</u>	<u>R70 000</u>
Unallocated	<u>R 40 000</u>	<u>R 30 000</u>			

Procurement activity

Activities: Procurement process					
	Buying	Receiving	Storage	Payment	Total
As allocated	R80 000	R48 000	R82 000	R75 000	R285 000 ←
Activity Drivers	Purchase orders	Goods receive notes	Space	Invoices	
Capacity		2 000	2 400	4 000	2 500
Driver rate	R40	R20	R20.50	R30	

Capacity wastage

Capacity	2 000	2 400	4 000	2 500	
Actual	1 800	2 300	3 200	2 800	
Wastage	200	100	800	- 300	
Driver rate	R40	R20	R20.50	R30	
Wastage (R)	<u>R8 000</u>	<u>R2 000</u>	<u>R16 400</u>	<u>-R9 000</u>	<u>R17 400</u>

Cost charged to cost objectives

	Buying	Receiving	Storage	Payment	Total
Total cost	R80 000	R48 000	R82 000	R75 000	R285 000
Less Wastage	-8 000	-2 000	-16 400	9 000	-17 400
	<u>R72 000</u>	<u>R46 000</u>	<u>R65 600</u>	<u>R84 000</u>	<u>267 600</u>

(Glad & Becker 1994: Appendix 1)

The above diagram illustrates that cost allocations and systems are crucial for effective financial management. At first the secondary processes are allocated to primary processes and then to activities. Cost should be allocated to activities by using resource drivers and eventually to outputs using the activity drivers that are needed for each unit of output. By using these activity drivers activity costs are then allocated to the cost objectives (outputs/services).

The capacity wastage indicates where spare capacity is available and is useful information to management as it identifies when the capacity of activity drivers are not fully utilised. The unallocated costs of the secondary processes should also be analysed for any wastage or fruitless expenditure. The management of provincial government departments should therefore manage the activity drivers to control costs.

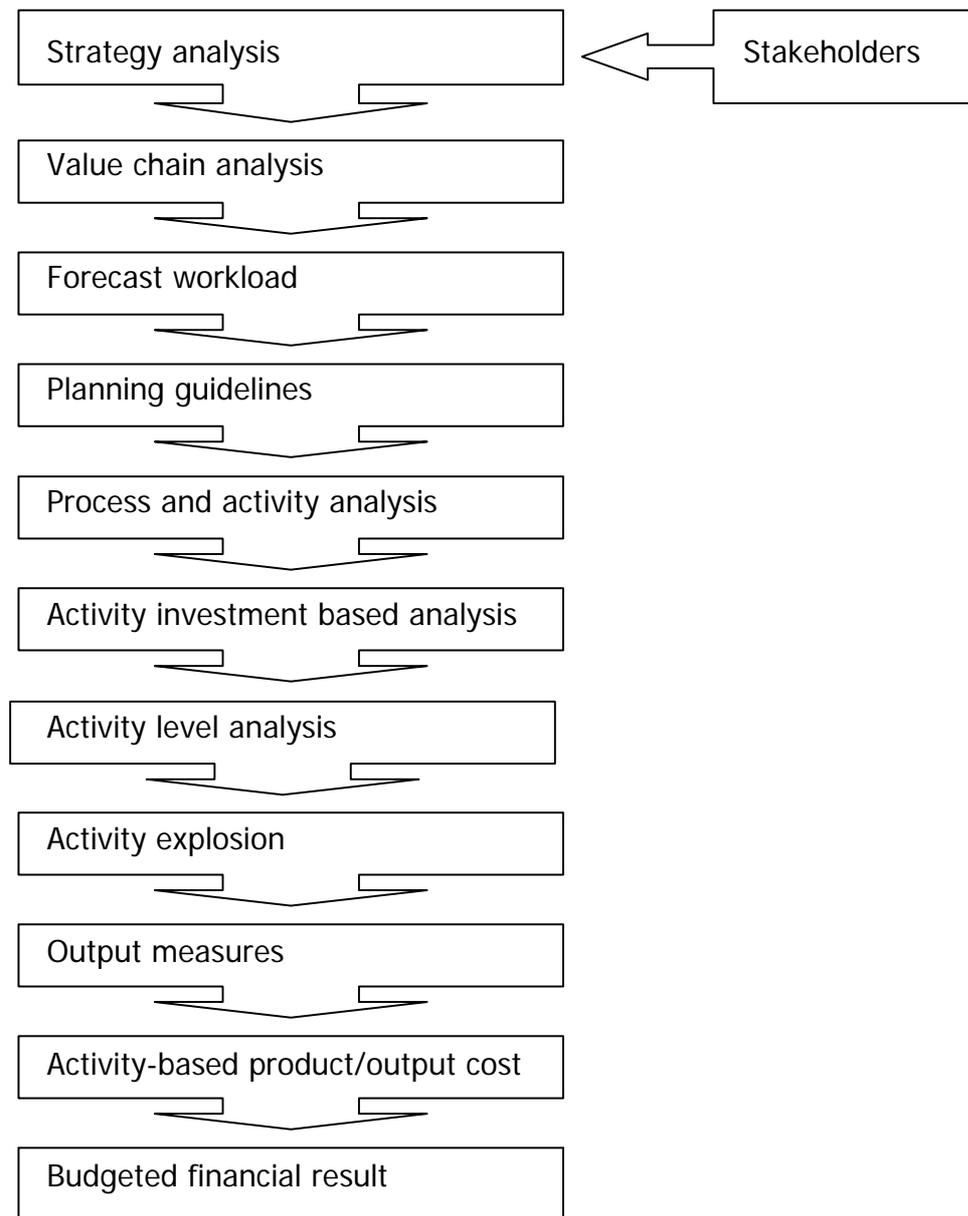
Under this subheading the principles of ABC were highlighted. The background of ABC is necessary in order to understand the activity-based budgeting (ABB) process that will be discussed in the next section.

5.8.3 Activity-based budgeting (ABB) process

The principles of ABB and ABC were discussed in paragraphs 5.8.1 and 5.8.2 where the importance was highlighted of the identification of activities that are needed to achieve the outcomes of an organisation. The activity-based budgeting process, therefore, should be in total harmony with the strategic planning process that was discussed in chapter three. It is clear that the needs of the stakeholders determine the strategies and the strategies in turn determine the activities that are needed to satisfy the needs of the stakeholders. The cost of these activities should be estimated or budgeted and then allocated (using ABC-principles) to the expected costs of the various outputs.

Glad and Becker (1994:156) illustrates the eleven steps of the activity-based budgeting process by means of the following diagram:

Diagram 13 Steps of the activity-based budgeting process



(Glad & Becker (1994:156))

These steps are discussed below (Glad & Becker (1994:156-158):

5.8.3.1 Strategy analysis

This step was already discussed in chapter three and deals with strategic planning of desired outcomes to satisfy the needs of the stakeholders. Strategy analysis is an important step to identify desired outcomes and outputs that are needed. The critical success factors are also identified at this stage and the balanced scorecard can be incorporated to facilitate this process. Activity-based budgeting will focus on the measurement and successful management of these critical success factors which form the base of performance measurement. The critical success factors need to be developed for each strategy. The strategy analysis is therefore an important element of activity-based budgeting as this provides the link with the strategic planning process and helps to formulate the framework within which the activity-based budgeting has to be developed.

5.8.3.2 Value chain analysis

An evaluation of the value chain will clearly indicate which of the current processes fit in with the proposed strategies and which do not. This step will help management to eliminate the non-strategic processes as far as possible. The organisation may be restructured or significantly simplified by virtue of an analysis of the value chain. A typical question addressed during this analysis is which processes could be outsourced.

5.8.3.3 Forecast workload

Workload forecasting entails determining product or output quantities that will probably be required by the stakeholders, taking the strategic direction and the value

chain into consideration. The quantities of outputs required can now be translated into workloads for the various processes of the organisation.

5.8.3.4 Planning guidelines

Planning guidelines consist of macro- and micro-economic guidelines provided by top management or other authoritative body. This may include factors such as guidelines in respect of assumed inflation, interest rates, exchange rates and other minimum output requirements.

5.8.3.5 Process and activity analysis

This analysis is done of the various activities of the identified process in paragraph 5.8.3.2. The activities within the processes should be identified and critically analysed. Processes should be redefined, analysed and restructured by eliminating inter alia., non-value adding activities within a process. Management can endeavour to simplify the indispensable activities and have them performed in a most cost-effective way. The organisation could possibly eliminate the non-value adding activities.

5.8.3.6 Activity investment based analysis (capital budget)

The affect of new capital investment should specifically be evaluated to determine the influence on future cost structures. Not only will cash flows be influenced, but the depreciation charge will have a major influence on cost structures. This can also be seen as the capital budget of an organisation and the effects thereof.

5.8.3.7 Activity level analysis

An activity-based budget system clearly exposes costs, what drives costs and how cost will behave under different circumstances. This step will give management a better understanding of costs, what causes those costs and how costs will change at different levels of activities. This step will assist management to identify the activities that generates costs.

5.8.3.8 Activity explosion

Costs of activities are now budgeted for per cost element and per activity. The level of understanding required of the organisation makes this a valuable exercise in itself. This projection of activity cost could then be used by line- or programme managers to evaluate the reasonability of the budgeted figures. Historical trends and cost patterns should be reflected in these projections and they can be adjusted with known changes in factors such as inflation and interest rates or expected wage increases.

5.8.3.9 Output measures

Output measures of cost drivers need to be determined for all activities in order to calculate activity rates for product or output costing purposes. The rates are used to calculate the expected output cost.

5.8.3.10 Activity-based product/output cost

The activity-based budgeting exercise culminates in the calculation of the budgeted costs of the various processes, activities and products or outputs. Important decisions can normally be taken based on the information that is made available.

Costly processes or activities can be re-engineered and costly outputs can be eliminated or outsourced.

5.8.3.11 Budgeted financial result

All the information is now available to prepare a budgeted income statement, which will reflect the budgeted surplus or loss. All the items in the income statement will be supported by accompanying schedules of the activities of the relevant processes.

Diagrammatic the above steps can therefore practically be illustrated as follows:

Diagram 14 Illustration of activity-based budgeting: Roads

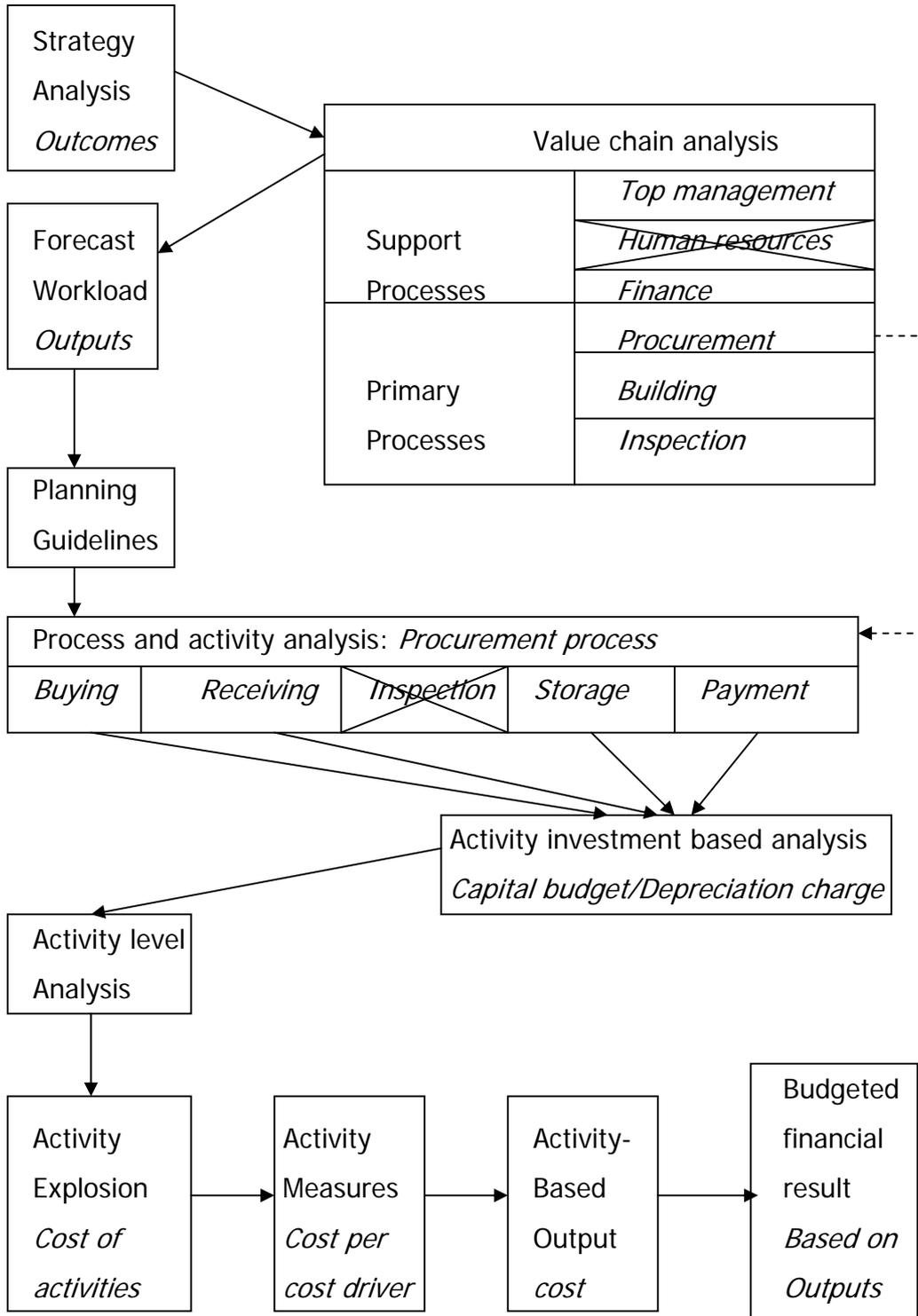


Diagram 14 illustrates the steps for an activity-based budget for the building of new roads. The human resource section/process for instance does not add value or may be outsourced while the inspection activity of the buying process does not add value. The high quality raw materials supplied by approved suppliers will make this activity unnecessary.

The logic of activity-based budgeting is that it is outcomes driven. The number of outputs are identified to satisfy the outcomes that are needed. The processes and activities are then identified to deliver these outputs. The costs of activities are budgeted and allocated to the outputs by using the activity measures or cost drivers.

Activity-based budgeting is a new concept that can add value to the budgetary systems of provincial government departments. The following section explains the benefits of ABB over conventional budgeting methods.

5.9 ADVANTAGES OF ACTIVITY-BASED BUDGETING OVER CONVENTIONAL BUDGETING

Although activity-based budgeting and conventional budgeting, such as line-item budgeting, have a lot in common, certain important differences exist which should be emphasised. The majority of differences also highlight the advantages of activity-based budgeting over conventional budgeting (compare Glad & Becker 1994:167, Drury 2001:301, Folk et al. 2002:378):

- Activity-based budgeting focuses on the appropriate value chain necessary for the organisation to meet its strategic needs. The appropriate value chain is fundamentally questioned during the budgeting process;
- the forecasted workload is specifically determined from a perspective of the stakeholder/customer rather than from a constraint or limiting factor perspective;

- activity-based budgeting questions the existence of each process and each activity in requiring it to be classified as value-adding or not;
- activity investment analysis is more specific and comprehensive because it evaluates the investment of funds in activities as well as the influence on current and future cost structures;
- activity-based budgeting is built on the relationship between the cost driver and the cost of an activity and this enables the budget process to exploit activity costs into the resources required at each level of activity;
- activity-based budgeting requires a detailed level of understanding of the processes and activities. This will enable management to have a better understanding of what causes costs;
- activity-based budgeting also focuses on the support costs and their relationship with primary activities. Support cost in many organisations form a major proportion of the total cost and also need to be related to the outputs produced and the relevance in the organisational value chain;
- activity-based budgeting focuses primarily on the requisite activities to operate an effective organisation;
- when an activity-based budgeting system is linked to a quality management system, a specific focus on wastage can be incorporated in the budgeting process. The activity-based budgeting helps to determine the value of wastage at the point it occurs. Wastages are identified when outputs do not utilise all the available resources; and
- activity-based budgeting focuses on the full cost of a process that may be extended over various departments.

It is apparent from the empirical study that it will be possible to implement ABB as 88% of the respondents indicated that departments can be subdivided into activities. Eighty-one per cent (81%) of the respondents were of the opinion that ABC will be applicable in provincial governments. ABB, therefore, will be easy to implement if ABC can be introduced in provincial government departments.

It is apparent from the abovementioned that activity-based budgeting will assist management to understand the activities in their provincial government departments better. Management can identify which activities are needed for the various levels of output and which do not add value; what resources will be required by these required activities and whether any surplus capacity exists at these activities.

5.10 CONCLUSION

In this chapter the nature and various types of budgets were discussed while the shortcomings of the current budgetary systems in provincial governments were also highlighted. The chapter also addressed the key factors of an effective budgetary system. The harmony between accounting and budgetary systems and the integration thereof were described as well as activity-based budgeting, costing and management. Finally, the process for effective budgeting was discussed which included the various steps of the activity-based budgeting process.

Without identifying the desired outcomes in the planning and budgeting process, performance measurement will be of no use as no benchmark is identified. Flowing from this outcomes-based budgeting is a prerequisite of performance measurement.

The respondents of the empirical study gave an effective rating of 59% to the current budgetary systems implemented in provincial government departments. Various shortcomings such as the lack of integration of budgets with the strategies were highlighted by the respondents. Techniques such as the balanced scorecard and activity-based budgeting provide a logical link between strategies and the expected cost thereof. By applying these techniques line-managers will be obliged to budget on an outcomes basis that forms a base for performance measurement the main objective of this study.

The budgeting process and the accruals based accounting system should be an integral system in provincial governments. Eighty-one per cent (81%) of the respondents indicated that an activity-based costing system will be possible in provincial government departments. The costs of departments should therefore also be measured on an accrual activity-based costing basis. Activity-based budgeting, which is a logical outflow of activity-based costing should be introduced at all departments as it focuses on the budgeted costs of the outputs to meet the desired outcomes.

In this chapter outcomes-based budgeting and budgeting process were discussed. The monitoring of results by means of accruals-based reporting will be dealt with in the next chapter. Actual results should be reported in such a manner that it enhances control and assists management on the reviewing of the performance of an organisation. Reporting is an important step towards performance measurement.

CHAPTER 6

PREREQUISITE FOR PERFORMANCE MEASUREMENT: PART 3

ACCRUALS-BASED REPORTING

6.1 INTRODUCTION

Two of the three prerequisites of performance measurement were discussed in the previous two chapters, namely competent and committed managers and outcomes-based budgeting. Reporting on an accruals basis is the third prerequisite for performance measurement as actual results have to be reported in order to measure performance. Performance measurement, therefore, is dependent on effective reporting.

In chapter two accruals-based reporting was also identified as one of the three categories for effective financial management. The promotion of effective financial management is one of the objectives of this study. Accruals-based reporting includes features of sound financial management such as accrual accounting and reporting, a focus principally on results rather than on process and rules in an environment that displays the existence of appropriate internal controls, ex post accountability replacing ex ante control and excellent information and advice.

Financial reporting underwent fundamental changes over the past few years. These changes were driven by the ever growing and different needs of the users of financial information. The traditional role of finance operatives in both public and private sectors were being challenged. The demand for value-adding financial analysis skills is replacing the need for bean counting-skills, for number crunching and transaction

processing. In part, this has been driven by better technology, but more significantly by the realisation that accountants will be required to provide decision support, not just accounting data for organisations to be effective.

The public service entities at all levels of the public sector are currently in the process of implementing new accounting and reporting systems. The accounting systems are to be modified to incorporate accrual accounting and the financial reporting models are upgraded to move closer to those used in the private sector.

Reporting should be internally and externally. Internal reporting is for management to control and measure performance of an organisation and external reporting is for those stakeholders outside the government to determine if their needs are met. Internal reporting is part of management accounting where the emphasis is on decision-making for the future whilst external reporting is part of financial accounting where the emphasis is on summaries of financial consequences of past activities. Thus, to report internally and externally management should have a useful and reliable information system in order to evaluate the performance of the entity. The information system needs to ensure full and proper records of the financial affairs of the public sector entity. This information system needs to be designed in such a way as that costs can be determined and the key performance indicators indicated. These are the desired outputs to be considered as essential by management in their assessment of the success or failure of an organisation. Costs, that are determined on an accruals basis, should be allocated to activities and processes and eventually to the various outputs. In chapter five this was referred to as activity-based costing (ABC) that links the budgeting process with the reporting process.

In this chapter the main features of accrual accounting and reporting are highlighted, together with the advantages thereof, compared to the conventional cash basis. The implementation problems to introduce accrual accounting for the first time are emphasised. The different users of financial reporting are identified together with

their respective needs as well as for the differences of internal and external reporting. Internal reporting is discussed together with the implementation of accruals-based cost allocations to all the various activities and processes that are required for each output. Finally, the features of external reporting are discussed.

6.2 ACCRUAL VERSUS CASH ACCOUNTING

For many years the public sector applied the cash basis of accounting. However, with the implementation of the PFMA the public sector is obliged to apply the accruals basis of accounting. The next paragraphs will highlight the differences between cash basis of accounting and accruals basis of accounting.

6.2.1 Limitations of cash versus accrual accounting

Traditional accounting in the public sector focused on inputs and control over expenditure (Hoque & Moll 2001:318). Brown (1999:20) refers to this phenomenon as a system of appropriation control. In striving to achieve "appropriation control", the government has traditionally applied the "cash" basis of accounting whereby expenditure was measured by the payments that were made by public sector entities during a fiscal year.

The private sector is using the accruals basis of accounting and questions were asked why the accounting systems in the public and private sectors differ. Denning (2000:32) argued that if governments are different from private sector businesses, which are the case, then government accounting rules and their reporting models should also be different. It was also highlighted that a transaction is a transaction and it ought to be accounted for in the same way by all types of organisations. The latter view asserts that the nature of assets, liabilities, revenue and expenses, gains and losses does not change because they are held by the public sector instead of the

private sector. This argument would propose using the same accounting rules for both public and private entities.

The Private Sector Committee of the IFAC (2000: par. 199) defined the cash basis of accounting as a basis of accounting under which transactions and other events are recognised when cash is received or paid. It measures financial results for a period as the difference between cash receipts and cash payments.

The focus of cash accounting is on the “inputs” side only, with the main emphasis on the borrowing requirement should any shortfalls occur. The cash basis of accounting does not measure the resources consumed during the period under review, thus the actual costs of government programmes are not measured, controlled or reported. In the absence of accurate cost information, performance measures of efficiency and cost-effectiveness cannot readily be determined other than by performing relatively expensive ad hoc studies (compare Pauw et al. 2002:180-181 and IFAC 2001:217). The information available cannot appropriately satisfy the need to measure performance or control the operations under review and the accountability principle, therefore, is seriously impeded. Public sector entities, therefore, are encouraged to strive to adopt an accruals basis of accounting, as monitoring of performance against objectives will be easier.

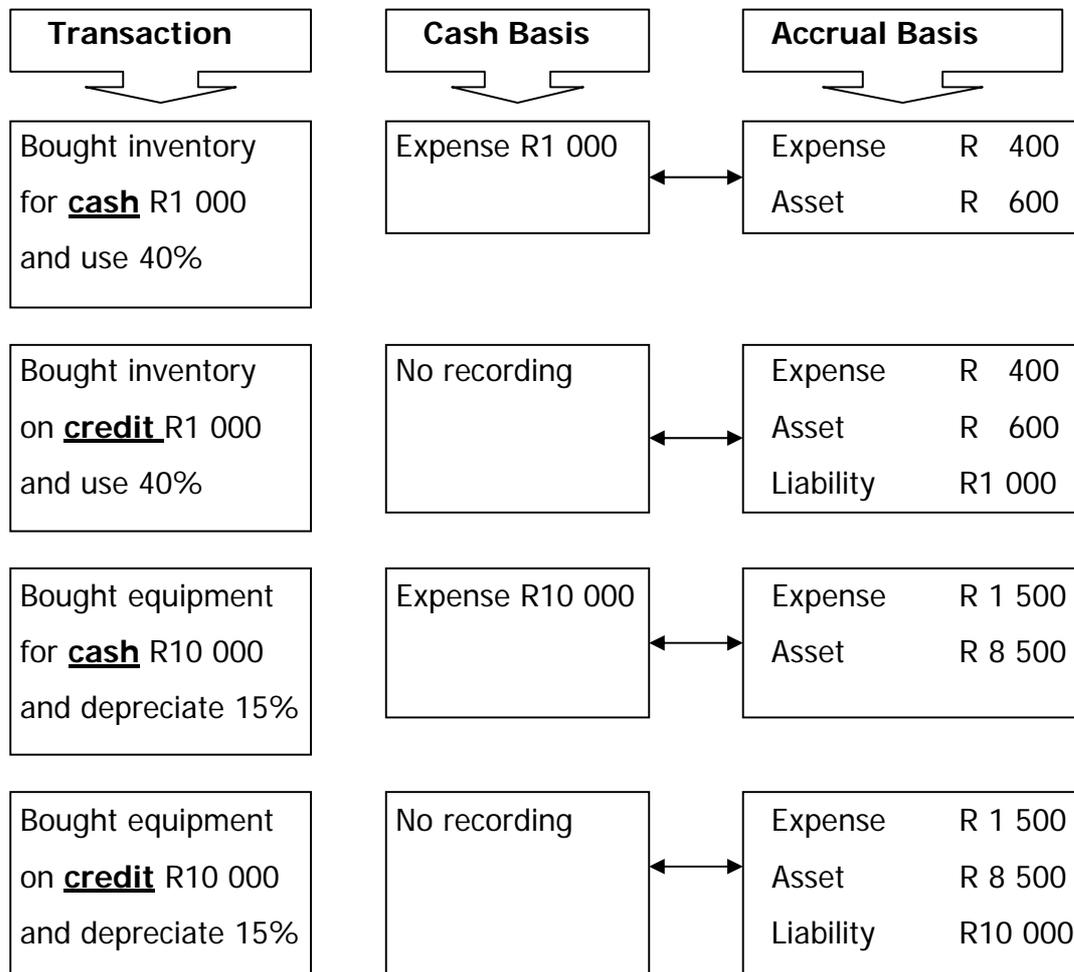
Keelan (2001:33) reported that the Ministry of Defence in the United Kingdom could not disclose the full cost of the Kosovo conflict because they were using the cash basis of accounting. The author also stated that: “After the Kosovo conflict, the Ministry of Defence came under fire again when its cash accounts omitted the cost of bombs dropped and a £1.3 million Hercules warplane destroyed on take-off, leading to allegations that defence officials have failed to disclose the full cost of Britain’s involvement.” This is a classical example of how the cash basis of accounting can distort financial information. The cost of a plane and the bombs were bought and expensed in previous accounting periods. The reason for the non-disclosure of these

expenses in that particular period is that no cash flow took place during the accounting period in which the Kosovo conflict took place.

The Private Sector Committee of the IFAC (2000:199) referred to the accrual basis as a basis of accounting under which transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and are recorded in the accounting records and reported in the financial statements in the periods to which they relate (compare Jones 1992:147 and Hoque & Moll: 2001:319).

The public sector is required by the PFMA to apply the accruals basis of accounting. This will not be easy as the information systems are not yet in place. The empirical study revealed that 64% of the respondents are of the opinion that the accruals basis of accounting will take four or years or longer to be implemented in provincial governments.

The differences between the cash and accruals basis of accounting are easily explained by means of an illustration, which illustrates the accounting treatment of four transactions. Note that under the cash basis only two entries are accounted for while under accrual accounting ten entries are recognised to reveal the effect of the four transactions. The following diagram was been developed to illustrate the above with reference to the differences in the two accounting bases:

Diagram 15 Cash versus accruals basis accounting

(Own diagram 2003)

It is clear from the above diagram that the cash basis only records a transaction when cash flow takes place and no other assets (except cash) or liabilities are recognised. This cash basis, therefore, does not reveal a true and fair reflection of the transactions. The accruals basis on the other hand reflects the resources used as expenses and also the resulting asset and liability. The IFAC (2000:par. 111-117) highlighted the following limitations of the cash basis (compare Hoque & Moll 2001:319 and Pauw *et al.* 2002:180-181):

- Increasingly, users of governmental financial statements expect governments to provide information on assets and liabilities, and the affect of current consumption on the stock of net assets held by a government. Cash accounting is not designed to meet these information needs. Its objectives are clear: to report cash inflows, cash outflows and changes in the cash balances held. Those who have more extensive information requirements need to either maintain supplementary records, or consider moving to a different basis of accounting;
- cash accounting focuses solely on cash flows within the current reporting period. It ignores other resource flows that may also affect upon the ability of a government to provide goods and services at a given time, and in the future (for example, although some jurisdictions may keep additional records, the cash basis does not account for accumulated borrowings and other liabilities). Nor does it record the benefits obtained from assets over a number of accounting periods. For these reasons cash-based information may be less relevant for decision-makers. Cash-based financial statements are sometimes supplemented with published cash forecasts, which provide an indication of whether future cash receipts will be sufficient to cover expected cash outflows;
- cash accounting limits the ability of the electorate to hold the government accountable for its use of resources. The provision of information only on cash flows means that governments can be held accountable for their use of cash, but no corresponding information is available with which to hold the government accountable for its management of assets and liabilities;
- The United Kingdom Green Paper on Resource Accounting (1994:par. 1.16) noted that one of the main limitations of cash accounting is the lack of information it provides on capital (assets): "While the present cash accounting system has served government well over many years, there are limitations to the information which it provides on capital. With cash accounting, spending on what is used over many years is recorded only when money is spent. No

subsequent account is therefore taken of whether the asset is still in use, has reached the end of its useful life, or has been sold.”;

- where a government prepares its financial statements on a cash basis it may collect and report supplementary information such as information on its assets. Such information may be collected as a preliminary step on a transitional path to the adoption of a different basis of accounting. This information may be disclosed in the published financial statements or it may be used solely for internal management purposes. The full benefits of collecting such information are able to be realised when the information is made available for legislative or public scrutiny;
- one of the advantages of cash accounting over other bases of accounting is that no need exists for preparers to exercise any judgement when determining the amount of cash flows for the period. To that extent it is less subjective than other bases of accounting. However, preparers still have the ability to manage the timing of cash flows by delaying receipts or payments until the next reporting period. This limitation was also highlighted by Jones and Pendlebury (1992:147) when stated that cash payments could be postponed by as little as 24 hours (into the next financial period) so that the financial report reflect a lower figure; and
- despite the apparent simplicity of cash accounting, in practice, financial statements prepared under cash accounting may not be easy for users to understand. This is largely due to the practice of reporting receipts and payments in great detail.

The above limitations are currently also experienced by the public sector. The respondents in the empirical study mentioned the following shortcomings of the cash basis of accounting that is currently applied in provincial governments:

- Full financial position is not reflected (no proper balance sheet is drawn up) showing assets and liabilities under control;

- no control over fixed and current assets;
- all expenses incurred are not accounted for;
- no records of debtors and creditors are kept;
- actual costs of services cannot be calculated; and
- it cannot be used as a base for performance measurement.

Flowing from the above it is clear that performance cannot be measured if the current system of accounting in provincial government departments is used. Accruals-based reporting, therefore, is an important prerequisite for performance measurement.

Woods (2000:7) is of opinion that any credible argument is no longer in the way of changing from a cash basis to an accrual basis of accounting. In the light of all the limitations of the cash basis it, therefore, is propagated that the public sector should change from the cash basis to the accruals basis of accounting. However, particular advantages and limitations of accrual accounting can also be found and will be discussed in the next section.

6.2.2 Advantages and limitations of accrual accounting

Keelan (2001:33) refer to accrual accounting as "resource accounting" and stated that resource accounting by nature removes distortions caused by the timing differences between receiving goods and services and paying for them and, more important the timing differences between paying for goods and services and actually consuming them.

The question, however, remains what the advantages of accrual accounting are that makes it preferable to the cash basis of accounting. The Australian Management Advisory Board as quoted by Du Randt (1999:10) answered this question as follows:

- The adoption of accruals basis of accounting across the government sector is critical to a best practice financial management environment;
- accruals accounting information provides a platform for better management of government resources, enhanced accountability and more meaningful performance management and therefore performance measurement. Stanton and Stanton (1997:1003) agreed with this by stating that the rationale for the imposition of accrual accounting is that it will provide information that will improve both resource allocation and accountability;
- it provides full true costs as transactions and other events are recognised when they occur, and not as cash is received or paid. Hoque and Moll (2001:319) added that accrual accounting is to improve decision-making by providing information on the full cost of operations and resources used to deliver services to the public;
- it allows a financial accountability framework that is based on assigning responsibility and performance assessment rather than on the imposition of controls and sanctions;
- it focuses managers on their roles and responsibilities in delivering outputs and integrates performance measurement into the decision-making process of managers; and
- the motto of no surprises is followed by focusing ahead by having reporting processes where relevant information is promptly provided to ministers and CEOs. Alexander (1999:52) agreed that accrual accounting matches revenue and expenses within a given financial period to avoid surprises in future periods.

The abovementioned advantages are also envisaged for provincial government departments. The respondents in the empirical study mentioned the following advantages to be expected by using the accruals basis of accounting in provincial government departments:

- Fair presentation of the financial position;
- accurate recording of liabilities (no surprises when payment have to be made);
- accurate recording and control over assets;
- reliable information regarding cost of services;
- matching income and expenses;
- better working capital (inventory, debtors, creditors and cash) management;
and
- better information for decision-making and performance measurement.

The improved visibility of assets and their value – and inevitably, the potential to dispose of them – will give broader insight for management. Keelan (2001:34) wrote the following about the adoption of accrual accounting at the Ministry of Defence in the United Kingdom: “It has helped focus management attention. A major property disposal programme and stock reduction exercise are already well in hand for those items that have become obsolete or are no longer needed.” If assets are not recorded they cannot be controlled. The same argument applies with liabilities. If you do not know what the liabilities are you cannot manage future cash flows.

With accrual accounting a clearer appreciation of liabilities is possible that will lead to better management over creditors and creating provisions for longer term liabilities. The identification and disclosure of liabilities will also not lead to any surprises in future periods.

To emphasise the importance of accrual accounting, the IFAC (2000: par. 327-328) concluded that the accruals basis of accounting provides users with financial information about such matters as the resources controlled by the entity, the cost of its operations (cost of providing goods and services), enhanced cash flow information, other financial information (in respect of financial ratios) useful in assessing financial position and changes in financial position, and in assessing whether the reporting entity is operating economically and efficiently. Accrual

accounting is essential if financial reporting is to provide information useful in evaluating the performance of government in terms of service costs, efficiency and accomplishments. It can assist users by providing better information for decision-making and accountability and by changing the way managers think and operate.

The only major limitation of the accruals basis compared to the cash basis is that the latter provides links to cash budgets and appropriations and may readily be understandable and timely (GRAP 1998:10). On the other hand it is important to note that the change to accrual accounting would not result in a total loss of cash flow information, as a cash flow statement is also required under an accrual accounting basis (GRAP 1998:11).

The respondents in the empirical study were of the opinion that the difficulties to implement accrual accounting in provincial government departments for the first time together with the change-over to a new information system can also be seen as limitations. The implementation of the accruals basis of accounting in provincial government departments will be discussed in the next section.

6.2.3 Implementation of the accruals basis in provincial government departments

According to the feedback from respondents in the empirical study with regard to the implementation of accruals-based accounting and management information it is clear that the implementation process will be a huge challenge in the provincial government sphere in South Africa. Interviews had also been conducted with various private sector Chartered Accountants (Coetzee Smit, Ernst & Young, Fisher Hoffman PKF, Gobodo Incorporated, KPMG, and PWC 2001), who have audit engagements in the public sector, staff of the Auditor-General and line-managers of provincial government. It is apparent from these interviews that among others, three major

obstacles have to be overcome in the implementation process of accruals-based information and these are highlighted in the ensuing sections:

6.2.3.1 The need for skilled human resources

The implementation of accrual accounting and GRAP requires certain new skills and competencies that financial officials and line-managers should require (see paragraph 4.5 in chapter four). According to the empirical study provincial government departments are currently experiencing a large shortage of highly qualified financial officials.

6.2.3.2 Change in mindsets of officials

The financial officials in provincial government departments need to undergo a mindset change to change from the old cash system that is in use for more than 25 years. Furthermore, taking the current recruitment policies of government into account such as the priority to appoint people from the previously disadvantaged groups, it will be difficult to recruit and appoint highly qualified financial people from this group as they did not have the opportunities to qualify in this study field.

The empirical study identified the following problems to recruit professional financial officials:

- Budget limitations to pay high salaries;
- negative image of the public sector;
- affirmative action and transformation priorities;
- negative perception on job assurance in the public sector; and
- financial skill shortages of those persons with a previous disadvantaged background.

It was also stated that most of the support financial staff in provincial government departments do not have the necessary education and financial background. Support staff needs to be trained and if there are serious knowledge and experience gaps are evident, qualified people must be recruited. New staff should also be trained as they should get familiar with the public sector environment.

If the gap of skilled human resources is not filled, the implementation process of accruals-based accounting information will be seriously hindered.

6.2.3.3 New information systems

The information systems in the public sector are outdated. The current accounting and information systems that are being used in provincial government departments are not user-friendly towards accrual accounting. From the interviews with external auditors and the Auditor General it became clear that the current information systems should not only be upgraded, but that a totally new integrated accruals based system should be introduced. As was discussed in chapter five, these systems should not only accommodate accounting information, but also an accruals-based budgeting and performance measurement system. Keelan (2001:34) reflected as follows: "Training staff and implementing new work practices for managers are all very well, but without overhauling and upgrading the system, the project will not be able to get off the ground."

6.2.3.4 Getting the fixed assets on the books

It is currently the practice in provincial governments to regard the purchases of property, plant and equipment as an expense and not as an asset (GRAP 1999:13). Asset registers should now be created by provincial government officials from limited information. The challenge to put values next to these assets and to record them will be an accounting nightmare.

The USA Governmental Accounting Standards Board (GASB) (1999:9) reported that the most problematic issue would be recording the assets of the government, including infrastructure, on a comprehensive, accrual based balance sheet. Transition rules will recognise these practical difficulties. Nevertheless, the Government Finance Officers Association (GFOA) in the USA is concerned about the difficulty of restructuring the cost of items such as water systems, highways, and public transport systems (GASB 1999:9).

The joint GRAP Project Team (1998:13) argued as follows: "Accounting for fixed assets will be a challenge as government has infrastructural fixed assets, for example roads, bridges and heritage assets. Information should be obtained in order to identify and measure the applicable assets". Roads, bridges, and heritage assets are not generally found in the private sector and the implementation of GRAP with regard to recognising these assets in the balance sheet will probably be difficult.

The above difficulties were evaluated by the respondents in the empirical study. The following importance factor ratings were highlighted by the respondents:

Table 8 Implementation difficulties of accrual accounting in provincial governments

Difficulty	Importance rating
Need for skilled finance staff	94%
Change in mindset of staff	93%
New information systems	92%
Getting fixed assets on the books	82%

The human factor is still the most problematic as the need for finance staff and the changing of mindsets of staff are the biggest challenges in the provincial government

sector. Other implications, referred to in literature and the respondents, are discussed in the next section.

6.2.3.5 Other implications

According to the empirical study and literature, the following aspects can also be seen as difficulties to implement accrual accounting:

- **Cost**

The whole process of introducing accrual accounting will be time consuming and will require skilled human resources. The cost of these changes should not be overlooked.

Keelan (2001:33), with regard to the transition of accounting systems of the Ministry of Defence (MoD) in the UK observed that it would cost the government around £200 million and that the move is thus an enormous undertaking. PWC, the MoDs accounting systems integrator, has called the transition the largest financial management and systems project in Europe according to the author. It is clear from this statement that the implementation of the accrual system will be costly.

- **Interpretation of reports**

Accrual reporting offers advantages such as the presentation of a balance sheet and cash flow statement, but a number of government specific issues relating to the preparation and interpretation of accrual reports need to be addressed. The Commonwealth and State Treasurers were of the opinion that accrual reports would not meet all their reporting needs and the limitations of these reports need to be understood by users (Clark-Lewis 1996:86).

- Changes in financial management

Apart from the challenge to apply financial management in the public sector the accounting information on which financial decisions is based will also change dramatically in future due to the implementation of accrual accounting and GRAP. The Australian Government has gone even further and decided to implement an integrated accruals-based resource management framework. The framework explicitly focuses on outputs and outcomes and thus complement the shift to a performance culture (MAB 1997:12).

- Consolidations

In order to prepare consolidated financial statements for government, the boundaries of government need to be known (all the entities that government control) and then how to combine financial information produced by the sub-entities (GRAP 1998:17). To enable Parliament to hold the government effectively accountable for its performance in the use of resources and management of assets, clarity on the boundaries is essential.

Governments control significant resources and stakeholders are dependent on their financial reports. The boundaries of the government reporting entity is crucial for good accountability. A poor boundary definition gives governments plenty of opportunity to leave important agencies or departments with large liabilities, such as Social Security, off the balance sheet. Governments must decide on the basis of consolidation to clarify which entities are to be incorporated in the consolidated financial statements and which entities should not be part of the consolidated statements (IFAC 2000: par. 25).

- Other accounting implications

The accounting statement on Inventory with regard to valuation and the statement on Disclosure of Retirement Benefit Information with regard to the creation of a liability for the first time may cause implementation problems, as the

current practice is also different from the proposed practice. The point of revenue recognition, specifically the various types of taxes and restricted grants from other governments or donor agencies, or from central government to the provinces, will be difficult to establish (GRAP 1998:13).

The whole process of implementation of accrual accounting should be phased in. Clearly, long lead times must be planned to design and introduce necessary systems, train staff and to collect required data (Brown 1999:21). Skilled and professional financial human resources should be recruited to assist the implementation process as the accounting and financially related applications require specialised knowledge such as of GAAP and accrual accounting. Training courses for current and future financial officials are a necessity. The information technology systems of government should be transformed in total from a cash-based system to provide the much needed accruals-based management information.

While it is true that the application of accrual principles does present some challenges, the benefits that it delivers in terms of better presentation of financial information of provincial government departments, outweighs any implementation difficulties.

The differences of cash and accrual accounting were evaluated in this section as well as the difficulties that could be experienced to implement the accrual basis of accounting for the first time. In the next section the users of financial reports and their needs will be discussed.

6.3 THE USERS OF FINANCIAL REPORTS AND THEIR NEEDS

Financial statements communicate the financial position and results of activities to the stakeholders. Financial statements can be seen, therefore, as the reporting mechanism by which the users (stakeholders) are informed. When preparing

financial statements, the objectives thereof and the users and their different needs, need to be identified in order to communicate the correct information. This will subsequently be discussed.

6.3.1 Objectives of financial statements

The objective of financial statements and reporting is to provide information about the financial position, performance and changes in financial position of an organisation that is useful to a wide range of users (to be discussed under paragraph 6.3.2.) in making economic decisions (SAICA, accounting statement of GAAP, AC 000:paragraph 12). Financial statements also show the results of stewardship of management, or accountability of management for the resources entrusted to it. Financial statements, therefore, enhance performance measurement processes of organisations. The empirical study, however, revealed a 52% rating for effectiveness of financial reporting in the provincial government sector. This rating is unsatisfactory and attention should be paid to improve the financial reporting structures in provincial governments.

A distinction is often made in practice between financial accounting and management accounting (Hongren 1999:2). Financial accounting focuses on external reporting that is guided by generally accepted accounting practice or in the case of the public sector generally recognise accounting practice (GRAP). Management accounting measures and reports financial information as well as other types of information that assist those managers inside the organisation in fulfilling the goals of the entity.

Two types of reporting, therefore, are available in order to satisfy the different needs of the users, namely internal and external reporting. The users and their needs will subsequently be discussed and paragraphs 6.4 and 6.5 will reflect on internal and external reporting respectively.

6.3.2 Users of financial reports

Financial reports should meet the common needs of the most users. According to the IFAC (2000: par 48) the principal users of governmental financial reports include (compare Jones & Pendlebury 1992:118 and Vorster et al. 2002:19):

- **Legislative and other governing bodies:** Legislative and other governing bodies (such as the executive authority referred to in chapter four) grant authority to governments and government entities to administer public financial affairs and resources. The legislative authority may use financial reports to assess the stewardship of resources of the government, compliance with legislation and other authorities, and the financial position and financial performance of the government.
- **The public:** The public includes taxpayers, electors, voters, special interest groups and recipients of goods, services and transfers provided or made by the government. Taxpayers are required to provide resources to the government and are interested in information about how the government has used the funds received in the current and previous years. The taxpayers are also interested in information on whether the government is managing to fund current goods and services out of current taxes collected.
- **Investors and creditors:** Investors in government securities and other creditors (such as external suppliers of goods and services) are entitled to information that allows them to assess whether the government is likely to be able to meet its commitments as they become due. This category of users may also have access to special purpose reports.
- **Rating agencies:** Some governments obtain finance from the national and international capital markets by issuing bonds or other financial instruments.

Rating agencies provide assessments of a creditworthiness of the government for the capital markets using standard categories such as A or AA. Rating agencies are primarily concerned with the “ability to service debt” of the government and their ability to repay that debt when it becomes due. Rating agencies, therefore, consider the nature and extent of the other obligations of the government, the asset backing of a government, the extent of its current and projected spending and its ability to generate the same or increased levels of tax revenue.

- **Other governments, international agencies and resource providers:** These users have similar information needs to investors and creditors. However, to the extent that the funding they provide may be earmarked for specific projects, these may also require information on compliance with the terms of the agreement and specific performance measures in relation to that project. International agencies are interested in the comparability of the financial statements of various governments and the use of complete disclosure.
- **Economic and financial analysts:** Economic and financial analysts, including the media, review and analyse information on behalf of other users.
- **Senior management:** Although senior management are internal users and have access to more detailed internal reports, often the general external reports provide a useful overview of the financial affairs of the entity for these users.

Seven users are listed above. The first six users will make use of external reports to satisfy their needs. The last user “senior management” will make more use of internal management reports to measure performance of the various activities. This

underlines the importance of the two reporting formats, namely external financial reporting and internal management reporting.

The importance of the external users of financial reports was evaluated by the respondents in the empirical study with regard to the Free State Provincial Government. The following importance ratings were indicated by the respondents:

Table 9 Importance ratings of external users of financial reports

External users	Importance ratings
Legislative bodies	89%
The public	66%
Investors and creditors	54%
Rating agencies	65%
Other governments	64%
Economic analysts	78%

From the above table it is apparent that legislative bodies and economic analysts are the most important external users the reports of the provincial government departments.

The users of financial information have been identified in this section. In the following section the needs of the users will be discussed in more detail.

6.3.3 Needs of the users

While all the information needs of these users cannot be met by financial statements, some needs are common to all users. Vorster *et al.* (2002:19) stated that the users of financial statements might have a wide range of information needs. Some groups of users may place a higher or lower priority on certain types of information than

other user groups while some user groups have similar information needs. The Public Sector Committee of IFAC considers that, taken as a collective group, users expect that governmental financial reports will help them to (IFAC 2000:par. 49):

- Assess the sources and types of revenue;
- assess the allocation of and use of resources;
- assess the extent to which revenue was sufficient to cover costs of operations;
- predict the timing and volume of cash flows and future cash and borrowing requirements;
- assess the ability to meet financial obligations of the government, both short- and long-term;
- assess the overall financial position of the government or entity;
- provide the public with information concerning those assets held on behalf of taxpayers, specifically information on ownership and control, composition, condition and maintenance;
- assess the financial performance of the government or entity in its use of resources;
- assess the economic affect of the government on the economy;
- evaluate government spending options and priorities;
- assess whether resources were used in accordance with legally mandated budgets and other legislative and related authorities such as legal and contractual conditions and constraints; and
- assess the stewardship over the custody and maintenance of resource of the government or entity.

The above can be seen as functions of financial reports and also relates to corporate governance. The three principles of corporate governance, namely openness, integrity and accountability must be satisfied. Financial reports should be transparent to users and should be prepared with the necessary integrity so that an organisation can give proper account of its activities.

Two reporting formats have been identified, namely internal reporting and external reporting. Internal reporting is for the internal users (management) and external reporting for the external users. In the following two sections the two reporting formats will be described in more detail.

6.4 INTERNAL MANAGEMENT REPORTING IN PROVINCIAL GOVERNMENTS

The importance of internal reporting for management in the provinces cannot be underestimated. Various aspects of internal reporting will be discussed in the following sections.

6.4.1 Importance of internal reporting

Internal reporting of financial and operational results is a key component of an effective management system. Unless managers receive information that is accurate, timely, relevant and of high quality, effective management and governance become difficult, if not impossible (Drury 2001:15). A performance measurement framework that is the objective of this study will also be impossible to implement.

The Guide for Accounting Officers prepared by National Treasury (2000:19) stated that the financial and operational information provided to managers, Ministers and MECs is usually presented in internal reports, to facilitate:

- Controlling the current activities of the organisation;
- planning its future strategies and operations;
- improving objectivity in the decision-making process;
- optimising the use of resources;
- measuring and evaluating performance; and
- improving internal and external communication.

The empirical study evaluated the importance of internal reporting. Ninety-three per cent (93%) of the provincial government respondents indicated that internal reporting is an important information tool in their departments.

Unlike external reporting, internal reporting is a less closely prescribed process and is largely built up by an organisation to suit individual needs. A range of common elements in the internal reporting process is present in most organisations that suggest a framework for best practice internal reporting. Internal reporting needs to be aligned to accruals-based financial statements, allowing a consistent basis for budgeting and management reporting.

The Australian Public Service operates in an accrual accounting and output-based budgeting format. The new environment see departments moving to define and cost their outputs, and to budget and account for all operations on a full accrual accounting basis (MAB 1997:55). Departments in Australia prepare a full accrual income statement, balance sheet and cash flow statement on a monthly basis. If the accrual system of accounting is in place, the South African provincial governments should be able to produce the same monthly reports as in Australia.

Financial management will, after accrual accounting is introduced, encompass the full accrual cost of outputs (also depreciation and employee entitlements) rather than simply the amount of cash received and spent. Departments should revamp their budgets and reporting systems on the same basis of accrual. The MAB (1997:56) suggested internal reporting should follow the KISS principle (Keep it Simple and Short). It should focus on highlighting Key Performance Indicators (KPIs). Using graphs and other visual tools, it seeks to analyse data. In short, internal reporting should be designed to present managers with high quality, value-added information and analysis to assist them to make decisions. Coates (1997:20) concluded by saying that better practice organisations have their internal management reporting system serving an integrated strategic planning, operational business planning, budgeting

and management system, prerequisites stated earlier to ensure effective financial management and performance measurement in provincial governments.

6.4.2 Users of internal reports

Internal management reporting is about presenting information for decision-making (compare Folk et al. 2002:20). The priority audience of internal management reporting is the executive and senior management. Sufficient information should be provided in the internal reports so that management can keep their fingers on the pulse of financial information. The users may also include all line managers in the organisation, with the proviso that too wide a distribution may not be best practice.

Internal reporting should therefore also reflect in particular qualities and objectives. The following section will deal with the qualities and objectives of internal reporting.

6.4.3 Qualities and objectives of internal reporting

Internal management reporting must process a number of qualitative qualities to assist managers to make decisions regarding the allocations and management of resources (Warren et al. 2001:3). According to Drury (2001:15-17) and Folk et al. (2002:20-24) effective financial reporting involves making decisions regarding the selection of information to be included in financial reports, its measurement and its presentation.

The following qualities should be present in financial reporting (compare Opperman et al. 2001:3-4 and Vorster et al. 2002:17-21):

- **Relevance:** Information must have value in terms of assisting users making and evaluating decisions about the allocation and management of scarce resources

and should be predictive regarding future situations confirmatory with regard to past evaluations.

- **Reliability:** Information must be free of bias or undue error and should faithfully represent the transactions and events.
- **Test of materiality:** Could the omission of relevant and reliable information affect decision-making regarding the allocation and management of scarce resources? The needs of the users should be considered.
- **Comparability:** Users of financial information need to be able to compare aspects of operations at one time, over time and between operations. Consistency, therefore, is important and any assumptions made in the production of the information need to be explicit.
- **Understandability:** Consideration should be given to the interest of the users without sacrificing relevance or reliability of the information.
- **Timeliness:** Relevance and reliability of information is reduced if reports are not timely. A balance, therefore, is needed and material accuracy may need to be traded off to achieve timeliness.
- **Cost versus benefit:** Consider whether the cost of preparing the information presented in the reports outweighs the benefit of having it available. Cost of the first time production of information should be discounted.

A balance should be found between relevance and reliability in order to increase the usefulness of financial information. For example, information that can be supplied timely, may not be so reliable because of estimates, but is relevant to take decisions. Where costs of preparing information timely exceed benefits (relevance) the information will not be reported.

Seeing that the above qualities have to be balanced it is necessary to provide guidance on effective reporting. The following section deals with formats for effective internal reporting.

6.4.4 Effective internal reporting in provincial departments

Cilliers et al. (2001:24) believes that internal management reporting involves a series of balancing acts by giving sufficient detail to be meaningful without swamping the user with a tidal wave of data. According to Vorster et al. (2001:20) financial reports struggle to achieve this right balance between substance and user-friendly presentation. Management reporting is about presenting information regarding decision-making. It must be tailor-made for the organisation and needs to be clear, concise, logical, consistently structured and graphically presented (if possible).

The MAB (1997:57) suggested the following format for internal reporting:

- A clear graph on the first page to give an immediate snapshot of overall performance;
- the graph might be followed by brief, written comments regarding the overall performance;
- a set of accruals-based financial statements including an income statement, balance sheet and cash flow statement should be included. This will include a concise report on each major activity, reporting on highlights, using graphical presentations whenever possible and reporting on variances on budgeted results; and
- Key Performance Indicators (KPIs) should be the focus of the report. A number of KPIs should be honed down to bare essentials for the attention of senior management by using the balanced scorecard referred to in chapter three.

The National Treasury of South Africa also outlined the management information that should be included in internal reports and are, except for a report for each business unit, in line with the MAB of Australia (RSA National Treasury 2000:20):

- A graphical presentation of performance for the period showing KPIs (which must not solely be financial);
- a focus on those KPIs essential for the attention of senior management, balancing operational and financial indicators;
- written comments regarding the overall performance of the department;
- a set of financial statements (ideally compiled on the accrual base); and
- a concise report from each major business unit, highlighting operating results and variances against the budget.

As can be seen from the above, these reports should be concise and to the point. It also includes both financial and non-financial information. The empirical study revealed the following importance ratings for the various aspects of internal reporting in provincial governments:

Table 10 Formats of internal reports in provincial government departments

Format of internal report	Importance rating
Geographic presentation	83%
Written comments	77%
Full set of financial statements	70%
Concise report on variances from the budget	85%

From the empirical study it is clear that internal reports in provincial governments should be concise and that graphical presentation and a condensed variance report is more appropriate. A full set of financial statements is not concise enough and had the lowest rating.

The financial information provided in the internal reports should at least be on an accrual basis. The costs of the services provided should be accurate so that management can rely on them to take decisions. The following few paragraphs deal with accruals-based internal reporting which include costing systems.

6.4.5 Accruals-based internal reporting

Under the accruals-based accounting system all income and expenses should be recorded and recognised when they occur. The internal reports should also be on an accruals basis and should reflect what the true costs are of all the delivered outputs and the accrued income in a certain period. Using the balanced scorecard, as was discussed in chapter three, a detailed analysis of cost information should be conducted. Managers of organisations require accurate information of the full and true costs of their outputs or services in order to decide on the efficiency of the delivery of the services or whether services should be outsourced.

Sixty-three per cent (63%) of the respondents in the empirical study indicated that their provincial departments do calculate the costs of their outputs. Seeing that the cash basis of accounting is used, the accuracy of these costs are doubtful as all the resources consumed are not accounted for under the cash system of accounting.

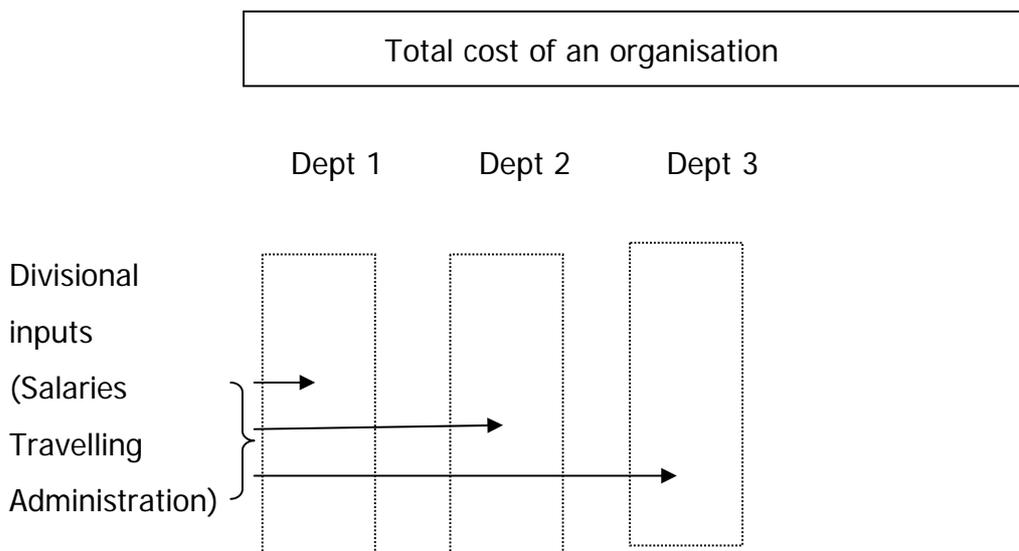
The only way to do accurate costing of outputs is to use an activity-based system as was discussed in chapter five. The production of detailed cost information is by no means easy, nor can it happen overnight as all the information systems should be in place.

The importance of accurate costing of outputs or services cannot be overemphasised. Management needs to know the true costs of services to take the necessary decisions such as whether to outsource or not. The following section deals with the different approaches of costing of outputs.

6.4.6 Costing of outputs

Traditional cash-based accounting in governmental departments generate financial information by taking a vertical slice of the organisation and reporting how much was paid for salaries, travel, administration, furniture and other items. While this type of information will often be of value to an organisation, it does not show the full cost of an output or provide managers with information which is relevant to their operational decision-making process. Diagram 16 illustrates the traditional costing methods:

Diagram 16 Traditional costing methods.



(MAB 1997:74)

Two emerging external drivers will require that the future focus and generation of cost information be different in nature to the above. These drivers are:

- The requirement by the Treasury Regulations for departments to budget and report on an accruals basis for outputs; and

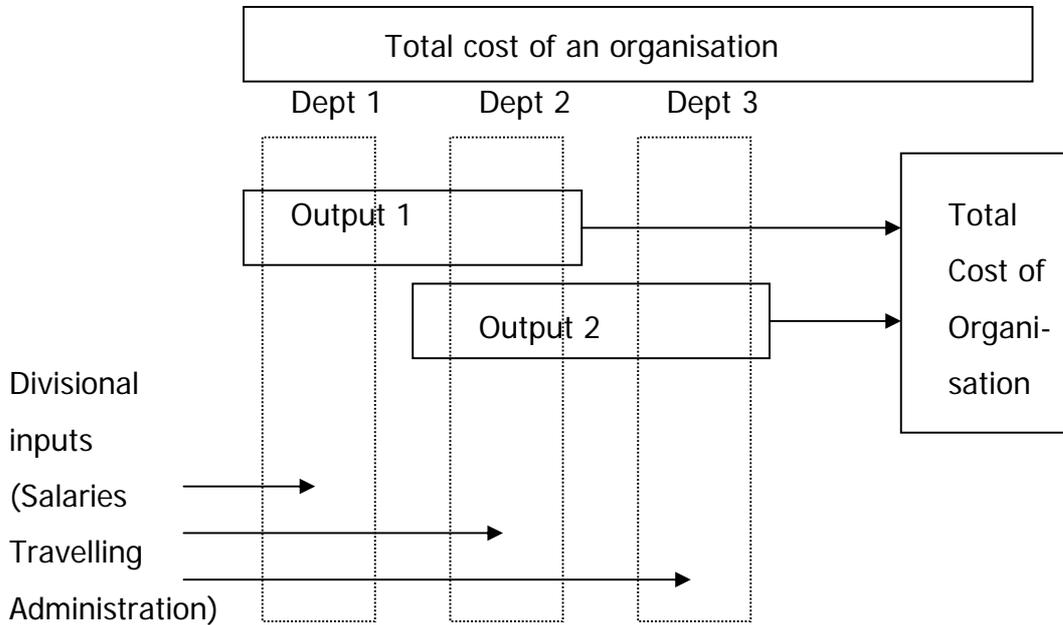
- The ideal situation for departments to market test or benchmark the delivery of many of their functions (compare IFAC 2001:par. 323).

Both will require agencies to know the full cost of delivering goods and rendering services to external consumers. While these will require high level cost information, agency managers will benefit from the development of costing systems that provide more detailed data – information that is aligned to their decision-making needs.

Outputs are the goods and services the government agencies produce to contribute to the desired outcomes of the government. Outputs are not processes, nor are they goods and services provided internally to the organisation, such as corporate services. To facilitate the costing outputs, the cost of all contributing overheads and internal support processes (the indirect costs) must be included to provide a complete picture of what is the actual cost to deliver the products and render services of an organisation. The IFAC (2001:par. 323) stated that in order to assess efficiency in an organisational unit it is important that outputs are measured on the same basis as the resources consumed (inputs) to produce them.

In order to cost the outputs fully and accurately, costing systems should be based on a horizontal slice of an organisation collecting the costs of each functional group that participates in the production of a specific output. This horizontal slice is illustrated in Diagram 17:

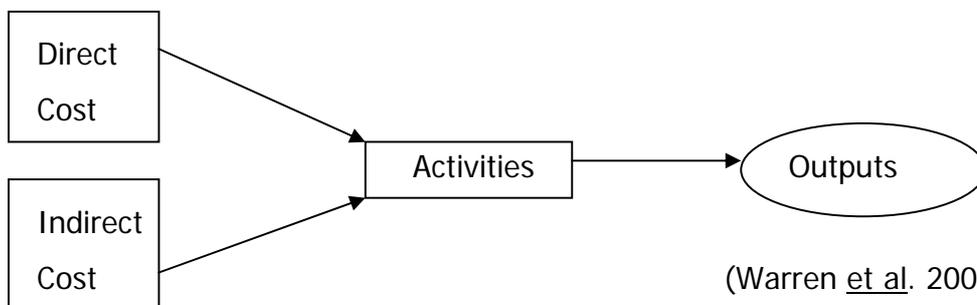
Diagram 17 Output costing methods



(Drury 2001:157)

By reporting accurate output costs, an organisation clearly articulates what it has been established to do, which outputs the agency will deliver, and what they will cost. The activities that are required for each output are important and diagram 18 shows the shift in emphasis away from satisfying external demands to one where the operations of the organisation are being analysed to learn where gains in efficiency and quality can be made.

Diagram 18 The emphasis on activities



(Warren *et al.* 2001:377)

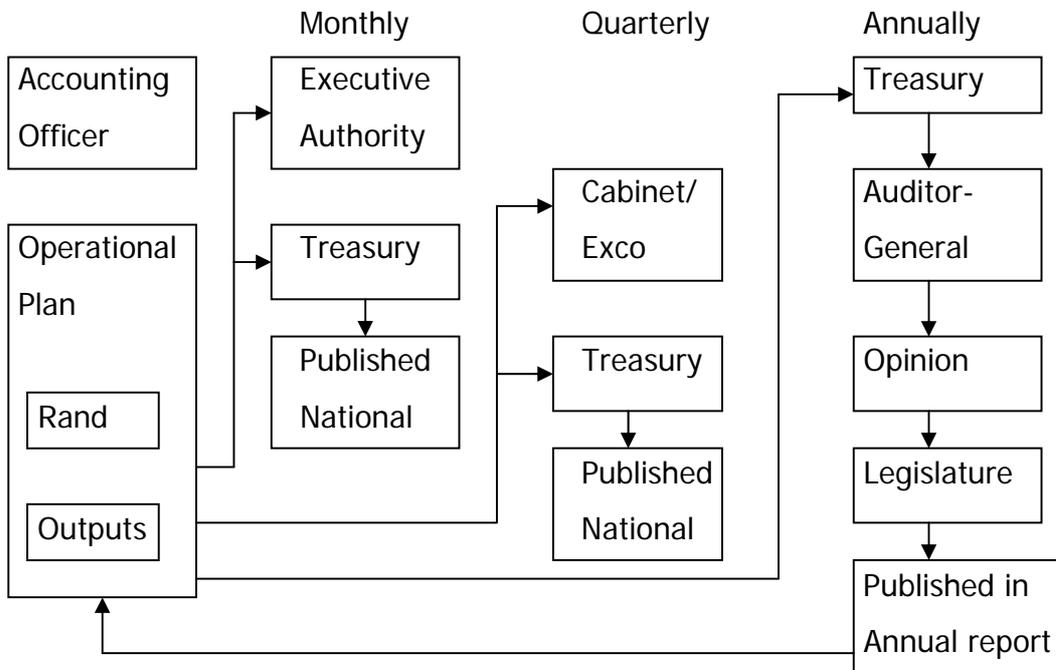
Here the focus is on activities and the emphasis is on managing and costing of the activities, not outputs. This costing model is called Activity Based Costing (ABC) that was discussed in chapter five.

The internal reports dealing with costs of services should be frequent and timely. If the cost of outputs is too high, management should intervene as quickly as possible. The following section deals with the frequency of reports as required by the PFMA.

6.4.7 The internal reporting cycle

Improving the quality of information available to managers will be a crucial aspect in implementing the PFMA. The Act specifies a variety of reports, monthly, quarterly and at year-end, with different responsibilities for executive authorities and accounting officers (Section 40(1)(d),(4)). The requirements are illustrated in the diagram below:

Diagram 19 Monthly, quarterly and annual reporting



(Du Plessis 2001:6)

6.4.7.1 Monthly reports

Within 15 days of the month-end, the accounting officer must submit to the relevant treasury and executive authority, information on (RSA National Treasury 2000:21):

- Actual revenue, expenditure and transfers for that month, in the format determined by the National Treasury;
- actual expenditure on any conditional grants;
- projections of anticipated expenditure and revenue for the remainder of the current financial year, in the format determined by the National Treasury; and
- any material variances and a summary of actions to ensure that the projected expenditure and revenue remain within the budget.

The provincial treasury must also submit a statement of transactions affecting its revenue fund (in the prescribed format) to the National Treasury before the 22nd day of each month. The head of the provincial treasury must certify that the information has been verified. Monthly reports to the executive authority should at least contain the information provided to the Treasury, and be complemented by quarterly reports on:

- More detailed information on the state of finances;
- detailed information on corrective measures taken (disciplinary action);
- progress on implementing the PFMA (internal controls, audit committee, clearing of audit queries); and
- non-financial information to enable measurement of progress against service delivery indicators also as objectives.

6.4.7.2 Quarterly reports

Every quarter, the National Treasury will publish a statement in the Government Gazette detailing the revenue and expenditure of each of the ten revenue funds, with actual performance against the budget for each vote (National Treasury 2000:21).

Accounting officers should expect the press, parliamentary committees, non-governmental organisations (NGOs) and the public to monitor the progress of their department through these reports. Information on grants made must also be reported in terms of that PFMA. The accounting officer effecting the payment must report to the relevant Treasury on the funds transferred to each government entity within 15 days of the end of every quarter.

Both the monthly and quarterly reports do not refer to outputs but are still focused on expenditure control. It is clear, therefore, that the strategic objectives are not linked with the internal reporting systems as required by National Treasury. This shortcoming should be addressed by provincial governments.

The empirical study revealed the following frequency of internal reporting in the provincial government departments:

Table 11 Frequency of internal reports in provincial governments

Frequency	Percentage of occurrence
Monthly	100%
Quarterly	42%
Half-yearly (not required by PFMA)	28%
Yearly	50%

From the feedback of the respondents it is clear that internal reporting in provincial government departments takes place at least every month. Some departments in the provincial government even have half-yearly reports that are not required by the PFMA.

The final report is the annual report. It can also be used for internal purposes but these reports are mostly used as the final report on all the activities of the organisation for the year under review as well as the financial position at the end of that year. This report will be discussed in the next section.

6.5 ANNUAL EXTERNAL FINANCIAL REPORTING

The annual report is similar to a final report on all the operations and events that took place during a particular year. It communicates a final summary of all the transactions by means of different statements within the report. The annual report is normally audited and will be accompanied by the report of the auditor. The following paragraphs deal with the nature of the annual report.

6.5.1 Nature of annual reports

The accountability cycle will be completed with the issuing of an annual report. The PFMA requires each department to publish an annual report, which includes financial statements that fairly presents the state of affairs, its financial results and its performance against predetermined objectives (Du Plessis 2001:6). The PFMA defines financial statements in section 1 as:

- A balance sheet;
- an income statement;
- a cash flow statement;
- any other statements that may be prescribed; and
- any notes to these statements.

The RSA National Treasury (2000:5) stated in the Guidelines for Annual Reporting that annual reporting includes not only financial statements, but also general information, human resources management programme performance, audit reports, financial statements and other financial information. The purpose of this document is

to provide guidelines on annual reporting to departments, trading entities and constitutional institutions. An attempt has been made to incorporate annual reporting requirements as set out in the various policy documents, namely the Constitution, 1996, the PFMA, 1999, the Treasury Regulations and the Public Service Regulations, 1999.

According to the RSA National Treasury (2000:22) the annual report should also indicate efficiency, economy and effectiveness of the department in delivering the outputs specified in the operational plan, as well as any other information required by the Legislature, and the use of any foreign assistance or aid-in-kind. This requirement forces organisations to report on the comparison between the outputs identified in the operational plan and the actual results. The concept of performance measurement, therefore, is a requirement of the National Treasury and is dependent on the reporting function of a department. The audit committee must comment on internal control in the department.

The empirical study revealed that 79% of the respondents were of the opinion that the annual reports of provincial government departments disclose comparisons with the outputs quantified by the operational plan. This question could have been misunderstood as respondents could have thought that outputs mean the budgeted amounts. The mere comparison of budgeted amounts with actual amounts is only a small part of performance measurement.

In accordance with the Constitution, the financial statements will be prepared under Generally Recognised Accounting Practice (GRAP) (compare Pauw et al. 182-183). The statements of GRAP will be approved by the Accounting Standards Board (ASB) (established under the Act) and will introduce accounting practices used in the private sector. The IFAC reported on 22 August 2001 in their Internet News Bulletin that the International Public Accounting Standards are to be adopted in South Africa as a basis for the development of GRAP. This will have benefits to South Africa as their

financial reports will be accepted worldwide and also the advantage of the cost-saving to develop these statements from scratch. According to the report, South Africa is the first country formally to announce that it intends to use the International Public Statements of Accounting Standards (IPSASs) for the development of GRAP for its national government and then also at provincial and local levels of government. Accrual accounting will be introduced: this recognises income and expenditure when the benefit is received or given, rather than simply reflecting the timing of cash flow. It also acknowledges the consumption of assets over their useful lives by provision for depreciation. Until GRAP is fully defined, and accrual accounting introduced over the next few years, the Regulations of the National Treasury specify GRAP for the year ending 31 March 2001, to be a set of cash-based statements that comprise:

- A balance sheet;
- an income statement;
- a cash flow statement; and
- notes and such other statements as may be prescribed by the ASB.

According to the RSA National Treasury (2000:22) the accounting officer must also, within five months of the financial year-end, submit the annual report of a department containing the audited financial statements and the report of the Auditor-General to the relevant Treasury and the Executive Authority. The reduced time-scale will enhance accountability and will result in actual figures being available in time to influence submissions to the next budget cycle.

In the empirical study the respondents was asked to indicate time scales for the issuing of annual reports in their provincial departments. The following table reflects these time scales:

Table 12 Time scale for issuing the annual report

Time scale	Percentage of respondents
Within three months	40%
Within four months	7%
Within five months	33%
Within six months	7%
Longer than six months	13%

Twenty per cent (20%) of the respondents indicated that the annual report of their provincial departments takes longer than five months to issue and therefore does not comply with the Treasury Regulations.

The RSA National Treasury (2001:47) also indicated that the cash basis would still be used for the year ending 31 March 2002. The statements must be prepared on a cash basis and be accompanied by the audit opinion of the Auditor-General. It is clear from the empirical study that accrual accounting will take several years to introduce and will most probably be introduced much later than 31 March 2002. Sixty-four per cent of the respondents said it will take four years or longer.

Seeing that the South African government will follow the international accounting standards it is necessary to look at the current requirements set by the IFAC. This will be discussed in the next section.

6.5.2 Requirements of the IFAC with regard to the annual report

The IFAC (2001:par. 297) stated that governing bodies of public sector entities need to publish, on a timely basis, an annual report (including financial statements), presenting an objective, balanced and understandable account and assessment of the activities and achievements of an entity, and of its financial position and performance

and performance prospects. To discharge their accountability for public resources, governing bodies need to ensure that they publish an annual report within a reasonable time - six months are recommended - of the end of the financial year and this includes (IFAC 2001:par. 298):

- Audited financial statements and report of the auditor;
- a statement of the aims and objectives of the entity, the performance measures against which future years' performance will be judged and a comparison of the actual performance achieved in the year covered by the annual report with the performance measures as determined in the previous financial year;
- a statement regarding the procedure for the appointment of the chairperson and other governing body members and the terms of their appointment, together with disclosure of the remuneration policy; and
- a statement which presents an objective, balanced and understandable commentary on the financial performance and position of an entity, its non-financial performance and on its future ability to meet liabilities and commitments.

Governing bodies of public sector entities are accountable for the stewardship and use of public resources. As such, the financial statements of the entity are those of the governing body and enhance accountability. It is important, therefore, that the governing body formally approves and adopts the financial statements of the entity and that a statement of their responsibility for the financial statements is included in the annual report. The IFAC (2001:par. 302) states that governing bodies of public sector entities need to include in their annual report a statement explaining (at least) that they have the responsibility for

- approving the budget or financial plan to provide authorisation for the acquisition and use of financial resources;

- the financial statements that fairly present the state of affairs of the entity as at the end of the financial year and the results of the operations for that year;
- maintaining an effective framework of control;
- ensuring the consistent use of appropriate accounting policies, supported by reasonable and prudent judgements and estimates; and
- ensuring adherence to applicable accounting standards.

Accounting standards are a prerequisite to financial accountability because compliance with accounting standards promotes the reliability, consistency and transparency of financial information. Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in the financial statements. Accordingly, compliance with accounting standards will normally be necessary for financial statements to give a fair presentation of operations during a particular year. The IFAC (2001:par. 309) stated that Governing bodies of public sector entities need to ensure that the financial statements contained in the annual report are prepared in accordance with International Public Sector Accounting Standards (IPSASs), or another authoritative and recognised set of accounting standards, and applicable legislation. As indicated earlier, South Africa is currently planning to harmonise its Statements of GRAP with the IPSASs of IFAC.

To demonstrate their commitment to high standards of governance, governing bodies need to include in their annual report a statement that they have complied with relevant standards or codes of governance; identifying the standards or codes adopted and identifying those standards or parts of codes with which they have not complied; for what part of the period such non-compliance continued, and giving reasons for such non-compliance. The IFAC (2001:par. 306) stated that governing bodies of public sector entities need to include in their annual report a statement on whether or not they have adopted standards or codes of governance. This statement

should identify the standards or codes adopted, as well as to confirm compliance therewith, or if not, in what respect compliance has not taken place.

The IFAC (2001:par. 305) stated that the annual report needs to be made publicly available. Therefore, organisations have the responsibility to present a balanced and understandable report to regulators that also include information required by statute. The inclusion of both qualitative and quantitative information may assist with the comprehension of the report. In chapter three a performance statement was proposed, which recommends both financial and non-financial measurements. This proposed performance statement should contribute to the comprehension of the annual report of provincial government departments.

6.6 CONCLUSION

In this chapter, the third prerequisite for performance measurement, accruals-based reporting was discussed. The essence of chapter was to demonstrate that performance measurement cannot be effective without accruals-based reporting. The users of financial information and their needs were addressed as well as the nature of internal and external reporting.

The respondents in the empirical study evaluated financial reporting in provincial government departments and gave a 52% effectiveness rating. This is mainly due to the use of the cash basis of accounting. It was found that the cash basis of accounting should be phased out as quickly as possible as it does not represent the true costs that are consumed by activities and outputs.

The cash basis is to be replaced by the accruals-basis of accounting that will take some time to introduce. Sixty-four per cent (64%) of the respondents were of the opinion that accrual accounting will take four years or longer to implement in provincial government departments. The implementation problems of accrual

accounting, such as the recruitment and training of skilled financial staff, changing the mindsets of staff and upgrading of information systems will furthermore take some effort. The challenge to get all the assets of provincial government departments on the books at a fair value will be a nightmare for any accountant.

With accrual accounting a clearer appreciation of liabilities will be available that will lead to better management over creditors and creating provisions for longer term liabilities. The identification and disclosure of liabilities will also not lead to any surprises in future periods when they are settled.

Internal reports in provincial government departments should include financial and non-financial information and should be timely, concise and to the point. Respondents indicated that geographical information, together with a concise variance report is the most effective way of internal reporting in provincial government departments.

Sixty-three per cent (63%) of the respondents indicated that they do perform cost allocations to outputs in their departments. These costs are inaccurate as the cash basis of accounting does not account for all the resources that are consumed through the various activities. An activity-based costing (ABC) system should be introduced as soon as the accruals basis of accounting is introduced in provincial government departments. The ABC system links outputs to the activities that are needed in a logical manner and also highlights wastage and unallocated expenditure.

Both the monthly and quarterly reports do not refer to outputs but are still focused on expenditure control. It is clear, therefore, that the strategic objectives are not linked with the internal reporting systems as required by National Treasury. This shortcoming should be addressed by provincial governments.

The external and internal reports of provincial government departments should deal with performance measurement and should not only deal with the control over inputs. This statement is in harmony with the objectives of this study. Reports should be output driven with comparisons of actual and targeted outputs both with regard to quantities and costs.

It can therefore be concluded that the previous three chapters that deal with the three categories of financial management, namely committed en competent line-managers, outcomes-based budgeting and accruals-based reporting also provide a complete picture of the prerequisites of performance measurement to complete the financial management process. The practical implementation of performance measurement that follows will propose a performance statement (see paragraph 7.3) that can be included in the annual financial statements to serve as a guide for future application in provincial governments and to coincide with the objectives of this study.

In the following chapter the practical implementation of the performance measurement approach will be discussed.

CHAPTER 7

PRACTICAL IMPLEMENTATION OF THE PERFORMANCE MEASUREMENT APPROACH

7.1 INTRODUCTION

In the previous three chapters the prerequisites of performance measurement, namely committed and competent line-managers, outcomes-based budgeting and accruals-based reporting were discussed. Although these three prerequisites are closely linked and integrated a chronological flow for the practical implementation thereof need to be followed.

In this chapter the practical implementation of the performance measurement approach will be highlighted. At first the practical flow for implementation will be illustrated and finally a performance statement is proposed.

7.2 THE PRACTICAL IMPLEMENTATION OF THE PERFORMANCE MEASUREMENT APPROACH

The author had a meeting with six senior auditors of the Office of the Auditor-General in the Free State with regard to the practicalities of the implementation of the performance measurement approach to financial management. The logical flow of activities that are required for implementation will be highlighted in diagram 21 and is also endorsed by the senior auditors of the Office of the Auditor-General and their comments are documented (Fourie et al. 2003).

The practical implementation of the performance measurement approach should be based on the fulfilment of the three prerequisites of performance measurement.

Unless managers are not committed and competent and if budgets and reports are not outcomes-based and accruals-based respectively, it will be impossible to implement the performance measurement approach.

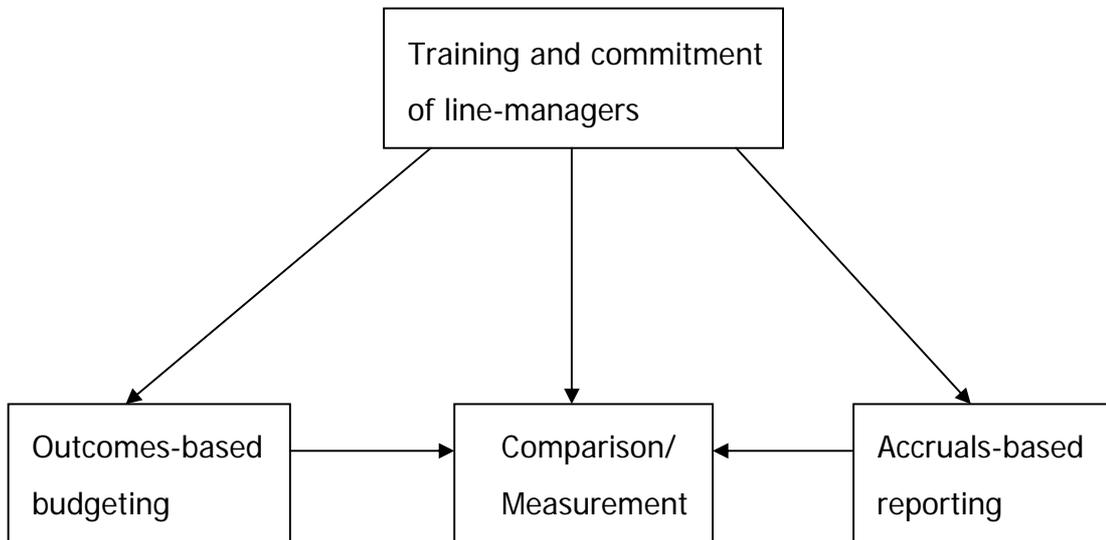
The basis for the implementation of the performance measurement approach is to get line-managers competent in their tasks and committed towards performance. Managers are to be trained on all the various aspects of budgeting and reporting. They should know the importance of the strategic planning process and how the operating budgets are linked to these strategies. Managers should also know the measures with which the performance of their provincial government departments will be evaluated. Performance contracts for managers should be implemented to enforce commitment towards performance at all required levels.

Managers should also be trained on how to interpret accruals-based information as they are currently used to the cash basis of accounting. Although cash information is not the emphasis of accrual accounting, managers should constantly be aware of future cash flows and be trained to interpret cash flow information from accruals-based data.

The training of managers and officials is therefore of the highest priority and should be seen as an important starting point in the implementation process. The whole implementation process is dependent on the competence and commitment of line-managers (Fourie et al. 2003). Workshops, which are practical-based should be introduced at the beginning phase of the implementation process.

Competent and committed line-managers can be seen as an important prerequisite for the implementation of the performance measurement approach to financial management. The implementation of the other two prerequisites, namely outcomes-based budgeting and accruals-based reporting is dependent on the effectiveness of line-managers and can be illustrated as follows:

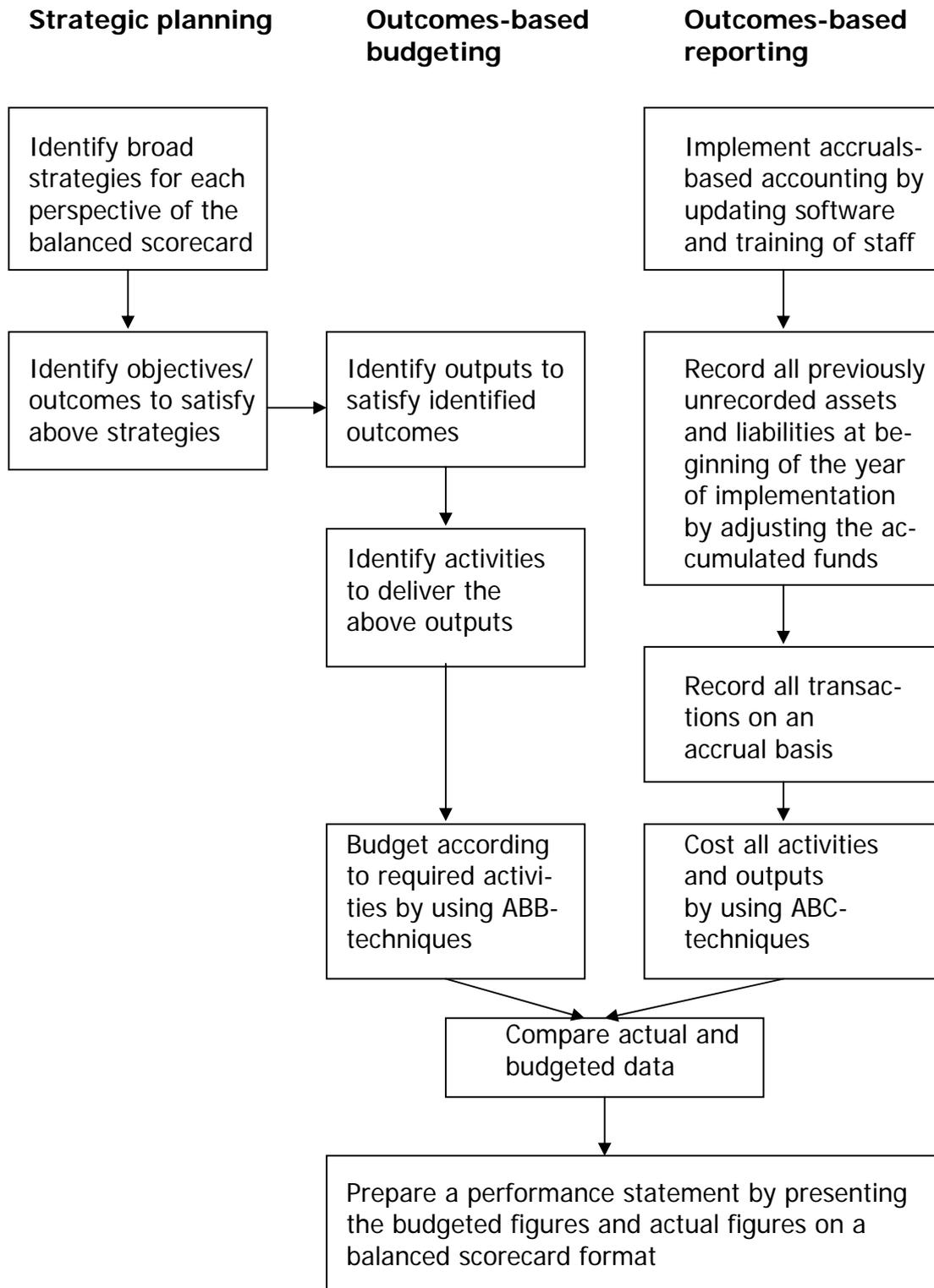
Diagram 20 The importance of the training and commitment of line-managers in the implementation process



It can be deduced from the above diagram that the involvement of line-managers in the implementation process of the performance measurement cannot be overemphasised. Line-managers are involved in the budgeting, reporting and measurement processes and should be educated and trained to fulfill these duties adequately. This should be the first step towards implementation of the performance measurement approach. Managers should also be contracted for commitment towards performance measurement.

The importance of the training of line-managers is highlighted above. The following diagram illustrates a practical flow chart for the implementation process of the budgeting and reporting processes of the performance measurement approach:

Diagram 21 Practical flow chart to implement the performance measurement approach



The above diagram illustrates the logic and chronological flow of activities for the implementation of the budgeting and reporting processes. It should be noted that the budgeting and reporting processes run parallel to each other and should be implemented concurrently. As discussed in the above paragraphs, these activities cannot be fulfilled without the assistance and support of competent and committed line-managers.

Outcomes-based budgeting can only be implemented if detailed strategic planning is performed whereby the strategies and objectives for the medium to long term are clearly identified. These strategies and objectives should be in line with the four basic perspectives of the balanced scorecard, otherwise the strategies could be out of balance if strategies are focused on particular aspects of the organisation only. Strategies and objectives should furthermore be revisited if a cut in the budget allocation occurs (Fourie et al. 2003). The objectives should also lead to the identification of outcomes that an organisation wants to achieve in the medium and long term.

After the planning phase is completed the strategies should be incorporated into the budgeting process whereby outputs are identified to satisfy the desired outcomes that are highlighted in the planning process. These outputs can also be seen as the required service delivery of an organisation. Outputs are also used as measures to determine performance.

If the required outputs are clearly defined, managers should determine all the activities that are required to deliver these outputs. These activities should be analysed in detail to determine all the resources that are required for each activity. The required resources will indicate the cost drivers which generate the costs of each activity on an accrual basis. The total cost of activities will be used to determine the cost of each output of that activity using ABB-techniques as discussed in chapter five.

In order to implement accruals-based reporting it is necessary to replace the current accounting software with an acceptable accruals-based information system which integrates the cash books, debtors, creditors, inventory, fixed assets registers and payroll. Currently the Basic Accounting System (BAS) is introduced in provincial government departments to accommodate accrual accounting (Fourie et al. 2003). Again, training of all finance staff is needed to implement a new accruals-based information system. This process will take some time and it is suggested that the old system must run concurrently with the new system to make sure that no data is lost in the process.

All the previous unrecorded assets and liabilities should be measured and recognised at the beginning of the year in which the accruals basis is implemented for the first time. The corresponding entry will be posted to the opening accumulated funds to get the opening balance of accumulated funds in line with the change in accounting policy. All the transactions for the year are then recorded on the accrual basis. If the comparative year figures should also be adjusted on an accrual basis the unrecorded assets and liabilities should be measured and recognised at the beginning of the comparative year. This might be costly and is not recommended.

The implementation of accrual accounting for the first time and the recognition of unrecorded assets and liabilities could take time and will be a costly exercise. It is envisaged that the process is phased in over two or three years on a predetermined time frame (Fourie et al. 2003).

If the accrual accounting is implemented, the cost of outputs can be determined by using ABC-techniques. According to the Office of the Auditor-General in the Free State the implementation of ABC in the public sector will be an expensive project as no accurate cost system exists at present in the Free State provincial government departments (Fourie et al. 2003). An ABC system should therefore be developed that harmonises with the current Basic Accounting System. Without the measurement of actual costs of outputs the cost effectiveness of service delivery of provincial

government departments cannot be assessed. These actual costs of outputs are then compared with the budgeted costs to measure performance.

A performance statement is proposed in the next paragraph that highlights the importance of the comparison of actual and budgeted figures. It also demonstrates how the whole process of strategic planning, budgeting and reporting can be integrated into one statement that also incorporates the principles of the balanced scorecard.

7.3 THE PERFORMANCE STATEMENT

Currently performance measurement does take place in provincial government departments and are audited by the Office of the Auditor-General. However, performance measurement is currently reported in an unstructured manner and forms part of the annual report of the accounting officer which is tabled for approval by the Executive Authority (Fourie *et al.* 2003). The annual report deals with the important programmes conducted during the financial year.

The objective of this study is to develop a performance measurement approach to improve financial management in provincial governments in South Africa. The results of performance measurement have to be reported in a structured manner. This study proposes a performance statement that reflects the performance results of all the important objectives of an organisation and which is in harmony with the balanced scorecard and the income statement.

The performance measurement approach highlights the importance of committed line-managers and the setting of benchmarks or predetermined measures to determine accountability of organisations. These benchmarks and measures are predetermined by using the strategies and desired outcomes of an organisation as a base that incorporates the planning and budgeting process. This was referred to as outcomes-based budgeting in this thesis.

Performance measurement can furthermore only be completed if actual results are reported and compared with the predetermined benchmarks or measures. Reporting is the final activity to conclude the performance measurement process. From the aforementioned it follows that performance measurement and reporting are closely related. This reporting should be on an accrual basis and should cost all the outputs accordingly. These costs should then be compared with the budgeted figures in a formal and orderly manner.

This section promotes a performance statement that can be included in the annual financial statements of provincial governments which should be in harmony with the strategies identified in the balanced scorecard and the income statement. It is suggested by the Office of the Auditor-General that the performance statement is accompanied by a set of notes that explains the level of efficiency of line-items in the statement (Fourie et al. 2003). These explanatory notes will enhance the benefit of the performance statement. Some of the senior auditors of the Office of the Auditor-General are also of opinion that the level of efficiency should also be reflected as an extra column on the performance statement itself. The extra column was not introduced in the proposed performance statement as it will make the statement to clumsy. Notes to the statement are therefore recommended.

The following diagram serves as a framework for the implementation of the performance statement to be included as part of the annual financial statements of the provincial government departments:

Diagram 22 The implementation of the Performance Statement

<u>Income</u>	Budgeted	Actual
	income	income
Authorised allocations	R XXX	R XXX

<u>Expenses</u>	Budgeted	Actual
	cost	cost
Total operating expenses	(R XXX)	(R XXX)

Stakeholders : Strategy: "to"				R XXX	R XXX
	Measures/ Indicators	Target- Outputs	Actual Outputs		
Objective (outcome) 1				XX	XX
Objective (outcome) 2				XX	XX

Internal processes: Strategy: "to"				R XXX	R XXX
	Measures/ Indicators	Target- Outputs	Actual Outputs		
Objective (outcome) 1				XX	XX
Objective (outcome) 2				XX	XX

Learning and Growth: Strategy: "to"				R XXX	R XXX
	Measures/ Indicators	Target- Outputs	Actual Outputs		
Objective (outcome) 1				XX	XX
Objective (outcome) 2				XX	XX

Unallocated expenses	R XX	R XX
Net operating surplus/deficit	R XXX	RXXX

Finance: Strategy: "to"				R XXX	R XXX
	Measures/ Indicators	Target- Outputs	Actual Outputs		
Objective (outcome) 1				XX?	XX?
Objective (outcome) 2				XX?	XX?

Net surplus/deficit	<u>R XXX</u>	<u>RXXX</u>
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The proposed performance statement indicates the objectives or outcomes that relates to the three operating perspectives of the balanced scorecard. The financial perspective (the fourth perspective of the balanced scorecard) represents the result of the statement. The measures represent the indicators that will be used to measure the desired outcomes or objectives. The measures also represent the sort of outputs required. If activities are required to deliver outputs, then costs should be involved. The targeted outputs/measures should be budgeted for by using activity-based budgeting techniques to determine the budgeted costs. The actual costs will also be determined by using activity-based costing techniques.

Critics might argue that costs cannot always be allocated to all kinds of outputs because some outputs can only be measured by non-financial measures. This may be true, but in the contrary it can also be argued that all outcomes require outputs and that these outputs should require activities or actions that will generate costs. The logic of ABC is that activities normally generate costs. For this reason it can be argued that it is indeed possible to allocate costs to most of the outcomes of objectives. In most instances no cost will be allocated to the financial perspective outcomes as targets are normally expressed as percentages or ratios. For this reason question marks are indicated on the proposed performance statement. Therefore the *net operating surplus or deficit* becomes the critical figure as a performance indicator and might be the bottom-line figure in the performance statement.

The objectives and desired outcomes should be in harmony with the strategy analysis and the balanced scorecard. The objectives identified under each operating perspective should not be more than five as only the critical success factors are to be focused on.

The unallocated costs/expenses may represent those costs that cannot be allocated to the various activities because it is impractical to do so (for example financial outcomes might indicate targets as a percentage of income) or it may represent unnecessary, wasteful or fruitless expenditure. It also represents all the costs not

allocated to the main objectives of an organization. These costs should be analysed in detail to highlight those costs that cannot be allocated and those that are fruitless or wasted capacity (see also paragraphs 5.8.2 and 5.8.3.2 with regard to capacity wastage).

The operating expenses are then deducted from the income to determine the net operating surplus or deficit. This is an important sub-total in the statement as it shows whether the operating activities are performed economically. The costs of all the objectives of the financial strategies, such as internal audit and control outputs, are then deducted from the operating surplus or deficit to determine the net surplus or deficit for the period in question.

The above statement should be prepared on the accrual basis of accounting to ensure that the costs of the outputs are correctly calculated and take into account all the resources that were consumed. Without a formal statement of performance that is officially published, performance measurement will be neglected by provincial governments. The practical implementation of the performance statement can unfortunately not be tested in practice as accrual accounting is not yet fully applied in the public sector.

It is recommended that the proposed performance statement be included in the annual financial statements. The performance statement should be in total harmony with the income statement.

7.4 CONCLUSION

In this chapter the practical implementation process of the performance measurement approach to financial management was discussed. It was noted that the implementation process should be aligned with the three prerequisites of performance measurement as discussed in chapters four, five and six.

The importance of the training of managers and officials was identified as the first step towards the implementation of the performance measurement approach. It was also suggested that managers should have performance contracts to strengthen their commitment towards performance measurement.

The logical flow for the implementation of outcomes-based budgeting and accruals-based reporting was illustrated with a flow chart. The identification of strategies, objectives, outcomes and outputs were highlighted. The chronological flow from outputs to activities and activity-based budgeting were reflected. This flow chart also indicated the accounting treatment of getting the previously unrecorded assets and liabilities on the books for the first time and emphasises the application of ABC-costing on an accrual basis.

Finally the chart shows that the budgeted and actual figures are to be reported and compared to measure performance. A performance statement that can be included in the financial statements is strongly recommended to accommodate the comparison between outcomes-based budgets and the reporting on actual results.

In the following chapter the conclusions and recommendations of this study are summarised.

CHAPTER 8

CONCLUSIONS AND RECOMMENDATIONS

8.1 INTRODUCTION

The purpose of this chapter is to summarise all the recommendations from this study. The chapter will also deal with findings from the empirical study.

The findings from the empirical and literature study and recommendations in respect of the three categories of financial management will firstly be discussed. Thereafter the findings and recommendations of performance measurement and the prerequisites of performance measurement, namely competent and committed line managers, outcomes-based budgeting and accruals-based reporting will be highlighted. Finally the need for performance statement (see paragraph 7.3 of chapter 7) will again be highlighted together with recommendations with regard to the practical implementations and further studies.

8.2 FINANCIAL MANAGEMENT IN THE PUBLIC SECTOR

During the past few years financial management and accounting in the public sector has been characterised by several developments on the international and national level. The objective of a financial management system in the public sector is to support management in their deployment of limited resources with the purpose of ensuring economy and efficiency in the delivery of outputs, required to achieve desired outcomes (effectiveness) that will serve the needs of the community. Performance measurement in provincial governments should be focused, therefore,

on the delivery of outputs to achieve the desired outcomes which is the objective of this study.

The abovementioned objective is not currently achieved in provincial governments. The respondents in the empirical study gave a 50% rating for the effectiveness of financial management in provincial government departments. It is important to note that respondents who are provincial government officials gave a 53% rating while the external respondents (auditors) gave a 46% rating. The reason for the unsatisfactory ratings is the lack of a sound, modern system of financial management. The respondents in the empirical study have listed the following shortcomings with regard to financial management in provincial government departments:

- Certain functions of financial management are shared by Treasury that has adverse implications on effective and autonomous operations. Responsibilities are also not clearly defined;
- a lack of experienced, knowledgeable, skilled and qualified staff;
- an incorrect placement of staff (not the right people for the job);
- the attitude of staff;
- the capacity to achieve stated goals and objectives effectively;
- the outdated accounting and information systems;
- a lack of knowledge of the PFMA;
- the transformation from financial control/administration to financial management;
- the integration between strategies and budgeting;
- a lack of training;
- the poor flow of documentation and information;
- the inadequate control systems;
- a lack of knowledge of accrual accounting and GAAP;
- a lack of structured policies and procedures in departments; and
- the systems do not support PFMA requirements.

The above shortcomings in provincial government departments can be grouped into three broad categories, namely inadequate and lack of knowledgeable staff; poor integration of budgets; and strategies and outdated control and reporting systems.

To overcome the shortcomings above various features for effective financial management were highlighted in chapter two. The following are the top ten features of effective financial management to be applied in provincial government departments as rated by the respondents in the empirical study (The importance ratings are shown between brackets):

- 1st (98%) Appropriate internal controls (reducing risks)
- 2nd (95%) Professionally qualified financial staff
- 3rd (92%) Excellent information and advice
- 4th (91%) Outcomes-based budgeting
- 5th (91%) Financial input to strategic and operational planning
- 6th (89%) Financial management the responsibility of managers
- 7th (88%) Outcomes-based management (performance agreements)
- 8th (86%) Accruals-based accounting and reporting
- 9th (83%) A focus on results rather than on processes and rules
- 10th (81%) Financial advice the responsibility of financial staff

In chapter two the above features were also grouped into three categories to address the three groupings of the shortcomings above. The three broad categories of the features of financial management that were identified as competent and committed line managers (places 2, 6, 7 and 10 above), outcomes-based budgeting (places 4 and 5 above) and accrual reporting (places 1, 3, 8 and 9 above). These groupings were evaluated in the empirical study and 97% of the respondents were in agreement with these groupings. The groupings can also be seen as three categories for effective financial management in provincial government departments which is an objective of this study.

A framework was developed from the three categories that were illustrated as the triangle of effective financial management (see diagram 2) in provincial government departments. The heart of this triangle represents the principles of corporate governance namely, openness, integrity and accountability. Performance measurement is shown as a requirement to meet the principle of accountability. Ninety-seven per cent (97%) of the respondents are of the opinion that corporate governance principles should be enforced in provincial governments as a basis for effective financial management.

It is recommended that financial management in provincial governments be based on the three categories, namely competent and committed line managers, outcomes-based budgeting and accrual reporting. These categories of financial management will address the current shortcomings that were highlighted by the respondents in the empirical study (see table 3).

The performance measurement as an important element of financial management and is also the key objective of this study. Without performance measurement the accountability principle will not be achieved. The following section will deal with the findings and recommendations of performance measurement.

8.3 PERFORMANCE MEASUREMENT

Government is increasing its interest in measuring and reporting on programme performance and increasing emphasis during budget reviews on programme performance. The objectives of performance measures include responding to accountability requirements, improving service delivery, and reducing costs while maximising output and increasing productivity in the entity.

It is recommended that performance measurement and the strategic plan be closely connected in provincial government departments. The information contained in the

annual report should reflect the achievements of provincial government departments in relation to the objectives as set out in the strategic plan and annual budget of an organisation for the fiscal year in question. If performance is not measured and controlled, the effort to formulate strategic plans will be of no use. Various respondents in the empirical study indicated that the lack of linking strategic plans with the budgets is currently a serious shortcoming in the budgetary system in provincial governments.

The balance scorecard is identified as an integrated set of performance measures (quantifiable targets and outputs) that are derived from each strategy of an organisation. It is recommended that the balanced scorecard is used by provincial governments to measure performance in relation to the strategies of a department.

The use of the balanced scorecard in provincial government departments was tested in the empirical study. Only 13% of the respondents indicated that their departments make use of the balanced scorecard. The empirical study also revealed that 89% of the respondents are of the opinion that any provincial government departments could be divided into the four perspectives as identified in the balanced scorecard model, namely stakeholder satisfaction, internal processes, growth and development and financial objectives. Seventy-one per cent (71%) of the respondents indicated that it will be possible to apply the balanced scorecard in provincial government departments. The other 29% retained their opinion and did not indicate that they were negative about the application. It is possible, therefore, to implement the balanced scorecard in provincial government departments as a basis for performance measurement.

In Section 1 of the PFMA the composition of financial statements is addressed and should include a balance sheet, income statement, cash flow statement, notes and any other statement that might be required. This thesis promotes the performance report to be utilised as the "other statement". This study recommends a

performance report or statement that can form part of the annual financial statements of provincial government departments (see paragraph 8.8 hereunder).

Ninety-six per cent (96%) of the respondents in the empirical study are of the opinion that a performance report or statement should be part of the annual financial statements of provincial government departments. A need, therefore, exists for such a statement at provincial government departments. This study also recommends that the performance statement combines the balanced scorecard and the income statement. The use of the balance scorecard can enhance managerial control and accountability in provincial government departments (See paragraph 8.8 for the framework of the proposed performance statement).

The study showed that performance measurement cannot be effective if managers are not contractually committed to perform. The study also revealed that performance measures should be linked with desired outcomes and outputs and furthermore that without an accurate reporting framework performance cannot be measured at all. Flowing from the above it is evident, therefore, that the three categories of financial management, namely competent and committed line managers, outcomes-based budgeting and accruals-based reporting, can also be regarded as prerequisites of performance measurement.

The following section deals with the findings and recommendations for the first prerequisite of performance measurement, namely committed and competent line-managers.

8.4 COMMITTED AND COMPETENT LINE-MANAGERS

Committed and competent managers form the first of the three prerequisites for effective financial management and performance measurement. An affective corporate framework, focused leadership, astute line-managers and a professional finance team are the key ingredients of a performance orientated organisation. Three categories of managers in provincial government departments were identified in chapter four of this study namely, the political head within the executive authority, the accounting officer/head of a department (CEO) and chief financial officer (CFO).

It is recommended that financial management be the responsibility of accounting officers (CEOs, Heads of departments) and not the responsibility of CFOs. Ten per cent (10%) of the respondents still think that financial management is not the responsibility of the CEO but that of the CFO. It is recommended that the CEO be held accountable for financial management in provincial governments.

The study tested the involvement of the political head in the financial management of a department. Only 38% of the respondents are of the opinion that the political head should be involved in the financial management in provincial government departments. This low rating is perhaps because the CEO is in accordance with the PFMA responsible for financial management in provincial government departments and not the political head. The executive authority, however, is responsible for policy choices and outcomes and will actively take part in the strategic planning process.

With the implementation of the PFMA the role of both financial and line-managers has to change dramatically. The empirical study showed that 93% of the respondents are of the opinion that management skills will have to change in future while 72% felt that leadership styles will also be influenced. The management and leadership styles provincial government departments should therefore be addressed by means of training and education.

The importance of the CFO can not be over-emphasised. They provide accurate, reliable and relevant information to the CEO so that the correct financial decisions can be taken. The importance of the CFO in provincial government departments is substantiated by the fact that 86% of the respondents in the public sector indicated that their department has a CFO employed. It is also clear from the empirical study that the CFO should not only be a number cruncher. He/she should at least be qualified professionally and be a critical thinker with a flexible mind. It is furthermore recommended that the CFO is employed in the top structures of a department who reports directly to the CEO.

The empirical study also revealed that only 41% of the financial staff in the Free State Provincial Government has some or other accounting qualification. From the study it became apparent that financial staff has a lack of experience, knowledge and skills. The respondents also revealed that financial staff has a negative attitude towards reform.

It is recommended that this situation needs a redress as it will be difficult, for example, to implement the new system of accruals-based accounting as required by the PFMA. Support staff in provincial government departments needs to be trained and if any serious knowledge and experience gaps are found, qualified people must be recruited. The empirical study also revealed that staff in provincial government departments who are not suitably placed should be reallocated to other departments to create posts for the recruitment of qualified finance staff.

The recruitment of suitably qualified finance staff will be costly for provincial governments as properly qualified financial people are earning huge salary packages in the private sector. The recruitment of suitably qualified CFOs should be of the highest priority. Salary scales for financial positions in provincial government departments, therefore, should be market-related.

The empirical study also revealed the lack of training as a serious shortcoming. It is recommended that financial managers in provincial government departments must be trained technically and be proficient in at least strategic management; workflow design; performance measurement; financial accounting; management accounting; internal control; internal and external audit; information technology; economy; negotiation skills; analytical skills; communication and other management skills. Neither in-house nor tertiary training programmes have given adequate attention to the above subject areas within the public sector context. It is recommended that these training programmes be included within in-house and tertiary courses. It is further recommended that it is not only the financial managers who need training but also the non-financial line-managers, such as the heads of departments (CEOs) of provincial government departments because they are responsible and accountable for financial management in their departments.

The human factor in effective financial management cannot be over-emphasised. People are the most important and most expensive asset. The features of good corporate governance cannot be applied in provincial government departments without committed and competent managers.

The following section will deal with the findings and recommendations for the second prerequisite of performance measurement, that of outcomes-based budgeting.

8.5 OUTCOMES-BASED BUDGETING

Outcomes-based budgeting means to budget with the desired outcomes in mind. This can only be achieved by an integration between strategic planning and budgeting. Budget reforms worldwide have replaced procedural accountability with accountability for results which entails performance measurement – the main objective of this study.

Various budgeting methods are used in the provincial government departments. The respondents in the empirical study indicated that sometimes there are more than one budgetary method is used in provincial departments. The empirical study revealed that line-item budgeting (67%); programme budgeting (87%) and zero-based budgeting (53%) are the most frequently used.

The respondents of the empirical study gave an effective rating of 59% to the current budgetary systems implemented in provincial government departments. The empirical study also revealed the following shortcomings in the current budgetary systems:

- Strategies and budgets are not aligned;
- costing skills of staff are lacking;
- lack of qualified and experienced staff;
- information systems are not in place;
- budgets are not zero-based but rather make use of the line-item budgeting method;
- inadequate monitoring and measurement;
- no communication with stakeholders to determine needs; and
- capital budgets (for long-term assets) are not separate and are still part of operating (not on an accruals basis).

It is clear from the above that apart from various shortcomings an important issue such as the linking of budgets with strategies is still lacking. This means that budgets are not outcomes-based in the provincial governments and would not serve any purpose in performance measurement as the desired outcomes cannot be used as a base for measurement.

The key factors for effective budgeting were also identified in paragraph 5.5 of chapter five. In the empirical study these factors were tested for their importance. The respondents gave the following importance ratings to the top ten factors for effective budgeting:

- 1st (96%) Management and monitoring of the budget
- 2nd (94%) Accountability and credibility
- 3rd (92%) Performance measurement/reporting
- 4th (91%) Discipline
- 5th (85%) Comprehensive
- 6th (84%) Link to medium-term expenditure framework
- 7th (83%) Transparency
- 8th (83%) Flexibility when circumstances change
- 9th (81%) Co-ordination and co-operation
- 10th (78%) Integration of recurrent and development budgets

In this study it is proposed that activity-based budgeting (ABB) be introduced with provincial government departments as ABB estimates costs of activities that are required to deliver the desired outcomes to satisfy the needs of the stakeholders. A few steps in a sound budgeting process can be set out as; firstly, the identification of outcomes and objectives; secondly, the identification of activities within programmes designed to meet the objectives; thirdly, the identification of desired outputs and performance measures (the use of the balanced scorecard is promoted); and fourthly, the preparation of these budgets by costing the activities within the

programmes in financial terms. This sound budgeting process harmonises closely with activity-based budgeting (ABB), which is also narrowly linked with an integral activity-based costing (ABC) system.

Strategic planning was highlighted as the starting point of the ABB. The strategies of an organisation must be in balance with all spheres of an organisation such as the needs of the stakeholders, financial requirements, internal processes and new developments (learning and growth).

The ABB process identifies all contributing activities, understands how the activities generate costs, and then determines the level of cost of each output. This process extends the use of activity-based costing (ABC) principles to budgeting. By using activity drivers activity costs are then allocated to the cost objectives (outputs/services). Capacity wastage that is useful information to management, are also identified when the capacity of activity drivers are not utilised in full.

The empirical study revealed that it is possible to apply ABC in provincial government departments. Eighty-eight per cent of the provincial government respondents are of the opinion that programmes can be divided in activities and 81% felt that ABC can be implemented in provincial government departments. It, therefore, is recommended that ABC and ABB be implemented in the public sector and hence also in provincial governments. Activity-based budgeting is a new concept that can add value to the budgetary systems of the public sector.

The following section will deal with the findings and recommendations for the third prerequisite of performance measurement, accruals-based reporting.

8.6 ACCRUALS-BASED REPORTING

Accountability and performance measurement is dependent on the budgetary control process. The control process of a budgetary system on the other hand is manifested in a sound accruals-based reporting system. Budgeting needs are to be integrated with accounting systems to make performance measurement in provincial government departments effective. If a similar basis of accounting is adopted for budgeting purposes and financial reporting, it will provide a framework of accounting information to present a more rational basis for planning and controlling of expenditure and for decisions about its financing.

The public service entities at all levels of the public sector are currently in the process of implementing new accounting and reporting systems. The accounting systems are to be modified to incorporate accrual accounting and the financial reporting models are upgraded to move closer to those used in the private sector. Accrual accounting accurately allocates costs to outputs (services) and this information provides a platform for better management of government resources, enhanced accountability and more meaningful performance management.

Line-managers of provincial government departments require accurate information of the full and true costs of their outputs or services in order to decide on the efficiency of the delivery of the services or whether services should be outsourced. Sixty-three per cent (63%) of the respondents in the empirical study indicated that their provincial government departments do calculate the costs of their outputs. Seeing that the cash basis of accounting is currently used in the public sector the accuracy of these costs are doubtful as all the resources that are consumed are not accounted for under the cash system of accounting. The only way to do accurate costing of outputs is to use an activity-based costing system on an accruals basis. It is recommended that an accruals-based ABC is introduced in provincial government departments.

The respondents in the empirical study evaluated financial reporting in provincial government departments and gave a 52% effectiveness rating. This unsatisfactory rating is mainly due to the use of the cash basis of accounting. The respondents in the empirical study mentioned the following shortcomings of the cash basis in provincial government departments:

- Full financial position is not reflected (no proper balance sheet is drawn up) by showing assets and liabilities under control;
- no control over fixed and current assets;
- all expenses incurred are not accounted in the process;
- no records of debtors and creditors are kept;
- actual costs of services cannot be calculated; and
- cannot be used as a base for performance measurement.

The respondents in the empirical study mentioned the following advantages to be expected by using the accruals basis of accounting in provincial government departments:

- Fair presentation of the financial position;
- accurate recording of liabilities (no surprises when payment have to be made);
- accurate recording and control over assets;
- reliable information regarding cost of services;
- matching income and expenses;
- better working capital (inventory, debtors, creditors and cash) management; and
- better information for decision-making and performance measurement.

The PFMA states that the cash basis is to be replaced by the accruals-basis of accounting. The implementation of accrual accounting will take some time to introduce as 64% of the respondents were of the opinion that accrual accounting will

take four years or longer to implement. It is recommended that the cash basis of accounting should be phased out as quickly as possible as it do not represent the true costs that are consumed by activities and outputs of provincial government departments.

The respondents are of the opinion that the implementation problems of accrual accounting, such as the recruitment and training of skilled financial staff, changing the mindsets of current staff and upgrading of information systems will take some effort and to get all the assets of the government on the books at a fair value will be nightmare to any accountant. While it is true that the application of accrual principles does present some challenges, the benefits that it delivers in terms of better presentation of public sector financial information, outweighs any implementation difficulties.

Two kinds of reporting exist in order to satisfy the different needs of the users, namely internal and external reporting. Senior management makes more use of internal reports to measure performance of the various activities whilst the executive authority and economist use external annual reports.

The empirical study evaluated the importance of internal reporting. Ninety-three per cent (93%) of the provincial government respondents indicated that internal reporting is an important information tool in their departments. The empirical study also revealed the following importance ratings for the various aspects of internal reporting:

- Geographic presentation 83%
- Written commentary 77%
- Full set of financial statements 70%
- Concise report on variances from the budget 85%

From the empirical study it is clear that internal reports should be concise and that graphical presentation and a condensed variance report is more appropriate. A full set of financial statements is not concise enough and had the lowest rating for management purposes. It is recommended, therefore, that a concise report with written comments and a geographical presentation be used in provincial government departments as a guideline for internal reports.

The empirical study also revealed the following frequency of internal reporting together with the percentages of occurrence:

- Monthly 100%
- Quarterly 42%
- Half-yearly (not required by PFMA) 28%
- Yearly 50%

From the feedback of respondents it is clear that internal reporting in provincial government departments takes place at least every month. Some departments in the provincial government even have half-yearly reports that are not required by the PFMA. The study also revealed that both the monthly and quarterly reports do not refer to outputs but are still focused on expenditure control. It is clear, therefore, that the strategic objectives are not linked with the internal reporting systems as required by National Treasury. This shortcoming should be addressed by provincial governments.

Both external and internal reports should deal with performance measurement and should not only deal with the control over inputs. Reports in provincial government departments should be output driven with comparisons of actual and targeted outputs both with regard to quantities and costs. These reports should create a performance measurement culture, which is the main objective of this study.

The need to report on financial and non-financial information by means of a formal performance statement is emphasised in the next section.

8.7 PRACTICAL IMPLEMENTATION OF THE PERFORMANCE MEASUREMENT APPROACH

It is recommended that the three prerequisites of performance measurement, namely committed and competent line-managers, outcomes-based budgeting and accruals-based reporting be implemented in a chronological manner. First the line-managers should be trained and educated or recruited if necessary. The implementation of outcomes-based budgeting and accruals based reporting should be executed parallel to each other as indicated in diagram 21 in chapter seven. This diagram finally also indicates the introduction of a performance report that will be dealt with in the next section.

8.8 THE PERFORMANCE REPORT

It is recommended that a performance report in the form of a performance statement be included as part of the annual financial statements of provincial government departments. The performance statement should be in harmony with the income statement and with the balanced scorecard. The statement compares the objectives identified in the strategy analysis with the actual results on an accrual basis.

It is further recommended that the performance statement be complemented with a set of notes collaborating on the efficiency in meeting the predetermined objectives. All the unallocated expenses that cannot be assigned to the main objectives of a government department should be investigated in detail to identify any fruitless expenses. The proposed performance statement is reflected in diagram 23.

Diagram 23 The proposed Performance Statement

<u>Income</u>				Budgeted	Actual
				income	income
Authorised allocations				R XXX	R XXX
<u>Expenses</u>				Budgeted	Actual
				cost	cost
Total operating expenses				(R XXX)	(R XXX)
Stakeholders : Strategy: "to"				R XXX	R XXX
	Measures/ Indicators	Target- Outputs	Actual Outputs		
Objective (outcome) 1				XX	XX
Objective (outcome) 2				XX	XX
Internal processes: Strategy: "to"				R XXX	R XXX
	Measures/ Indicators	Target- Outputs	Actual Outputs		
Objective (outcome) 1				XX	XX
Objective (outcome) 2				XX	XX
Learning and Growth: Strategy: "to"				R XXX	R XXX
	Measures/ Indicators	Target- Outputs	Actual Outputs		
Objective (outcome) 1				XX	XX
Objective (outcome) 2				XX	XX
Unallocated expenses				R XX	R XX
Net operating surplus/deficit				R XXX	RXXX
Finance: Strategy: "to"				R XXX	R XXX
	Measures/ Indicators	Target- Outputs	Actual Outputs		
Objective (outcome) 1				XX?	XX?
Objective (outcome) 2				XX?	XX?
Net surplus/deficit				<u>R XXX</u>	<u>RXXX</u>

In chapter 7 (paragraph 7.3), the above diagram is discussed in detail.

The above statement should be prepared on the accrual basis of accounting to ensure that the costs of the outputs are correctly calculated and take into account all the resources that were consumed. Cost allocations using activity-based techniques are also recommended.

Without a formal statement of performance that is officially published, performance measurement will be neglected by provincial governments. A performance statement that can be included in the financial statements is therefore strongly recommended to accommodate the comparison between outcomes-based budgets and the reporting on actual results.

New research opportunities came to the fore during this study. The topics for future studies are discussed in the next section.

8.9 TOPICS FOR FUTURE STUDIES

All the unanswered questions arising from this study should be addressed in future studies. The following list of topics may be of interest to financial management in the government:

- The development of a model to implement activity-based costing in the public sector;
- the application of activity-based budgeting in the public sector;
- a critical analysis of cost accounting systems in the public sector;
- a framework to implement the balanced scorecard in the public sector;
- a critical analysis of performance measurement systems in the public sector;
- a survey of the cost effectiveness of service delivery in the public sector;

- a framework for the implementation of accrual accounting in the public sector; and
- the development of a model to incorporate GRAP in the annual financial statements.

8.10 CONCLUSION

The performance measurement approach is promoted in this thesis to enhance the effectiveness of financial management in provincial departments. Performance measurement will only be possible by means of competent line-managers that is committed or contracted to perform; clearly identified outcomes through an activity-based budgeting process and by an integrated accruals-based reporting system to fulfil the transparency and accountability principles of corporate governance. A performance statement that can be included in the financial statements is proposed as a formal and orderly framework to report on performance measurement within an organisation.

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APPENDIX A

QUESTIONNAIRE

THE PERFORMANCE MEASUREMENT APPROACH TO IMPROVE FINANCIAL MANAGEMENT AT PROVINCIAL GOVERNMENTS IN SA

1. What is your current position? (Indicate by means of a circle)

- 1.1 Chief Executive Officer (CEO) Accounting officer
- 1.2 Chief Financial Officer (CFO)
- 1.3 Internal Auditor (Auditor General)
- 1.4 External Auditor (CA (SA))
- 1.5 Other (Specify)

2. Which provincial department/firm do you represent?

3. What is your highest qualification?

- 3.1. Academic: _____
- 3.2. Professional: _____
- 3.3. Other: _____

4. How many years' experience do you have?

- 4.1. Management: _____
- 4.2. Finance: _____
- 4.3. Other: _____

5. What is your perception of the standard of financial management in the public sector? Please rate it between one and five. Indicate (5) if it is excellent and (1) if it is considered to be poor.

1	2	3	4	5
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6. What do you think are the current shortcomings of financial management in the public sector? Please list them briefly.

7. Several developments have taken place in public financial management over the past few years. Please rate them between five (important) and one (not so important).

7.1	Generally Recognised Accounting Practice (Accrual)	1	2	3	4	5
7.2	Public Finance Management Act	1	2	3	4	5
7.3	Treasury regulations	1	2	3	4	5
7.4	Guide to Financial officials	1	2	3	4	5
7.5	Zero-based budgeting	1	2	3	4	5
7.6	Medium Term Expenditure Framework	1	2	3	4	5
7.7	Other (Specify) _____	1	2	3	4	5
	_____	1	2	3	4	5

8. Do you think that (1) management skills and (2) leadership style will change in the future as a result of the above?

8.1	Management skills	Yes	No
8.2	Leadership style	Yes	No

9. Corporate governance is based on the principles of openness, integrity and accountability. Are you of the opinion that financial management in the public sector should be based on these principles? Please rate them between five (important) and one (not so important).

9.1	Openness	1	2	3	4	5
9.2	Integrity	1	2	3	4	5
9.3	Accountability	1	2	3	4	5

10. What do you consider to be the features or characteristics of sound financial management in the public sector? Please rate the features below between five (important) and one (not so important).

10.1	Integral accrual accounting system	1	2	3	4	5
10.2	Strategic and operational planning	1	2	3	4	5
10.3	Focus on results rather than rules	1	2	3	4	5
10.4	Appropriate internal controls	1	2	3	4	5
10.5	<u>Ex post</u> accountability replacing <u>ex ante</u> control	1	2	3	4	5
10.6	Financial management: responsibility of managers	1	2	3	4	5
10.7	Financial advice: responsibility of financial staff	1	2	3	4	5
10.8	Excellent information	1	2	3	4	5
10.9	Professional financial staff	1	2	3	4	5
10.10	Key staff are linked to performance agreements	1	2	3	4	5

- 10.11 Clearly defined objectives and specified outputs
- 10.12 Clearly defined responsibilities of key staff
- 10.13 Executives have flexibility and discretion
- 10.14 Risk management principles are followed
- 10.15 Incentives to ensure improved efficiency; and
- 10.16 Non-financial measures for outputs
- 10.17 Other (Specify) _____

1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5

11. Do you agree that most of the features of financial management listed in par 10 above can be divided in three broad categories namely:

- 11.1 Committed and competent line-managers
- 11.2 Outcomes-based budgeting
- 11.3 Accrual's based reporting

Yes	No
Yes	No
Yes	No

12. Whose responsibility is financial management?

- 12.1 The Member of Executive Committee (MEC)
- 12.2 The Chief Executive Officer (CEO)
- 12.3 The Chief Financial Officer (CFO)
- 12.4 Other (Specify) _____

Yes	No
Yes	No
Yes	No

13. Does your department/institution have a Chief Financial Officer?

Yes	No
-----	----

14. The Chief Financial Officer should possess certain attributes. Please rate them between five (important) and one (not so important).

- 14.1 Professionally qualified
- 14.2 Number cruncher
- 14.3 A financial analyst
- 14.4 Good communicator
- 14.5 Critical thinker
- 14.6 Flexible mind

1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5
1	2	3	4	5

15. Are you of the opinion that a large portion of the senior finance staff should have accounting qualifications (at least Accounting III level)?

Yes	No
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16. This question is for CFOs (or if not appointed, the CEO) only.

16.1 How many senior financial staff is employed?

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16.2 How many do have accounting qualifications?

--

17. What kind of budgets is used for departmental purposes?

17.1 Line item budgeting

Yes	No
-----	----

17.2 Programme budgeting

Yes	No
-----	----

17.3 Zero-budgeting

Yes	No
-----	----

17.4 Activity-based budgeting

Yes	No
-----	----

17.5 Other (Specify) _____

18. Activity-based budgeting is a process where programmes of an institution are divided into activities. Do you think it is possible to divide the programmes of your institution into different activities and to budget accordingly?

Yes	No
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19. What is your perception of the standard of the budgetary control system in the public sector? Please rate it between one and five. Indicate five if it is excellent and one if it is considered to be poor.

1	2	3	4	5
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20. What do you think are the current shortcomings of the budgeting process in the public sector?

21. Government should acknowledge that public spending is an investment by taxpayers which should therefore be managed optimally. How can this be achieved?

22. The following are highlighted as key factors for effective budgeting systems? Please rate them between five (important) and one (not so important).

22.1	Transparency	1	2	3	4	5
22.2	Management and monitoring of the budget	1	2	3	4	5
22.3	Decentralisation	1	2	3	4	5
22.4	Co-ordination and co-operation	1	2	3	4	5
22.5	Integration of recurrent and development budgets	1	2	3	4	5
22.6	Flexibility when circumstances change	1	2	3	4	5
22.7	Discipline	1	2	3	4	5
22.8	Link to medium-term framework	1	2	3	4	5
22.9	Accountability and credibility	1	2	3	4	5
22.10	Comprehensive	1	2	3	4	5
22.11	Performance measurement	1	2	3	4	5
22.12	Other (Specify) _____ _____	1	2	3	4	5

23. What are the critical strategic issues facing your institution?

24. What are the strategies identified to meet the issues above?

25. Government departments are currently using the cash basis of accounting. What are the limitations of the cash basis of accounting?

26. What are the advantages of accrual accounting?

27. How long do you consider will it take to implement the accruals based system **fully** in the public sector as required by the PFMA?

27.1	Within 2 years	Yes	No
27.2	Between 2 and 3 years	Yes	No
27.3	Between 3 and 4 years	Yes	No
27.4	Between 4 and 5 years	Yes	No
27.5	More than 5 years	Yes	No

28. Various implementation problems for a fully integrated accruals based accounting system can be identified. These are listed below. Please rate them between five (important) and one (not so important).

28.1	The need for skilled finance people	1	2	3	4	5
28.2	New information systems	1	2	3	4	5
28.3	Getting assets on the books	1	2	3	4	5
28.4	Change in mindsets/skills of officials	1	2	3	4	5
28.5	Other (Specify) _____	1	2	3	4	5
	_____	1	2	3	4	5

29. Employing appropriately qualified and experienced financial officials could be difficult. What are the current problems experienced with this statement?

30. What is your perception of the standard of financial reporting system in the public sector? Please rate it between one and five. Indicate five if it is excellent and one if it is considered to be poor.

1	2	3	4	5
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31. Identify the different users of public financial reports. Literature identifies the following users. Please rate them between five (important) and one (not so important).

36. Does the annual report include an evaluation of achievements with regard to predetermined outputs?

Yes	No
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37. The desired outcomes are reached/achieved through the delivery of outputs.

- 37.1 Is the cost of the outputs currently calculated?

Yes	No
-----	----

- 37.2 If yes:

37.2.1 By departments; or

Yes	No
-----	----

37.2.2 Across the various departments

Yes	No
-----	----

38. Activity-based costing (ABC) makes use of two cost allocations. Firstly to the activities concerned and secondly to the outputs of these activities. Do you think that ABC can be introduced in your institution?

Yes	No
-----	----

39. According to National Treasury Regulations departments must produce monthly and quarterly reports. Are these reports prepared at your institution?

Yes	No
-----	----

40. Performance measurement is important for effective financial management. Are you of the opinion that a formal performance statement should be included in the financial statements of an organisation together with the other components such as the balance sheet, income statement and cash flow statement?

Yes	No
-----	----

41. According to the balanced scorecard approach performance measurement should include financial and non-financial measures and should be linked to the strategies of an organisation. What are the broad categories of these strategies?

41.1 Strategies for stakeholder satisfaction

Yes	No
-----	----

41.2 Strategies for internal activities and processes

Yes	No
-----	----

41.3 Strategies for innovation and learning

Yes	No
-----	----

41.4 Other (Specify) _____

42. Does your department make use of the balanced scorecard (see previous question) as an approach to measure performance?

Yes	No
-----	----

43. If question 42 is NO, do you think that the balanced scorecard approach can be applied in the public sector?

Yes	No
-----	----

44. What measures are currently in place to secure the improving of service delivery (maximizing output) and reducing the costs?

THANK YOU FOR YOUR TIME AND CONSIDERATION