Public Sector Financial Management

Dr. Eduardo Araral
Assistant Dean and Assistant Professor
Lee Kuan Yew School of Public Policy

OUTLINE

- Part 1: Scope and principles of public finance
- Part 2: Managing revenues, expenditure and debt
- Part 3: Performance based budgeting
- Part 4: Budget Execution / internal controls
- Part 5: Cost benefit analyses

Part 4:
Budget Execution: Internal Control Systems

Purpose of Internal Control Systems

- Ensure compliance with laws / regulations
- Ensure reliability of data / reports
- Facilitate efficiency and effectiveness of government operations
- Guard against misuse/inefficient use of resources;
- Safeguarding assets

Internal Control Systems

- Achieving budgetary objectives
- Reasonable assurance to the public regarding transparency and accountability
- A key foundation of good governance

Critical Areas of Internal Control Systems

1) Internal Audit
2) Management Information Systems
3) Cash vs. accrual accounting

1) Internal Audit

- Purpose is to review, appraise and report to budget managers on soundness and adequacy of internal controls

1) Internal Audit: International Standards

- Auditors have independence to make objective judgments
  - no direct management responsibility for what is being audited
  - Free to choose any transactions / topic for audit
  - Allowed access to all necessary information to come to an informed judgment

1) Internal Audit: International Standards

- IA is a management tool
- Requires mechanism for follow-up and action of audit reports
- Effective management of IA function
  - Sampling approach vs. extensive pre-audit
  - focusing on priority areas / key weaknesses
  - Evaluation of adequacy of internal controls

2) Financial Management Information Systems (FMIS)

- Key benchmark of budget reform and requirement for performance budgeting
- Benefits
  - allows prompt and efficient access to data (for transparency and accountability)
  - Strengthens financial controls, facilitating a full and updated picture of commitments and expenditures on a continuous basis
  - Assist in budgetary control and improves economic forecasting, planning and budgeting

3) Government Accounting: Accrual vs. cash based

- Cash Accounting – used in most traditional budget systems; records outlays and receipts only when they involve cash transactions
- Accrual accounting – recognition occurs with the exchange of liabilities and/or assets which is usually before cash flow

Table 3. Summary Comparison of Cash and Accrual Accounting

Criteria	Cash Accounting	Accrual Accounting
Ease of understanding	Simpler, but unfamiliar	Greater complexity, but familiar to more people
Ease of manipulation	Relatively easy to manipulate, but the issuance of the Cash Basis IPSAS is a big step forward.	Ease of manipulation depends upon accounting and auditing standards.
Comprehensiveness	Cash information only	Includes cash information together with other information
Usefulness for managing liquidity	Provides only basic information	Provides cash information and commitment information (e.g., payment arrears)

Criteria	Cash Accounting	Accrual Accounting
Non-financial asset management	No information provided	Provides information on asset use
Comparability	Countries use a range of cash accounting bases, policies are generally not explained well Not consistent with GFS and SNA	Countries use different accrual accounting standards Consistent with GFS and SNA
Measuring sustainability of fiscal policy / considering intergenerational equity	Very limited usefulness	Useful, but needs to be supplemented with additional information (e.g., demographic profiles)

Credibility	Limited	Credit rating agencies, lenders and the media are more familiar with accrual financial statements Can lead to lower borrowing costs
Basis for determining fiscal strategy	Limited	Good, in conjunction with cash information
Accountability	Limited	Provides information on accountability for resources (e.g., fixed assets)
Basis for product/ service pricing	Limited	Good
Disincentives for fraud and corruption	Limited	Better than cash, but depends on the internal control environment (among other things)

Accrual Accounting in OECD Countries

Box 31. OECD Practices: Reorienting toward Accruals-Based Accounting Systems

	Percentage of OECD Countries
1. If budget is on nonaccrual basis, what transactions are treated on an accrual basis:	
a. Interest on government debt	42
b. Civil servant pensions	25
c. Wages and salaries	17
2. Plans to change the accounting basis of the budget:	
a. Present additional accrual basis information	33
b. Introduce a full accrual basis	7
c. Full accrual basis considered and rejected	4
3. Accounts integrated into revenue and expenditure accounts to prepare financial statements:	
a. Assets	72
b. Liabilities	72
c. Government equity	68
4. Basis of accounting used for whole of government financial statements:	
a. Full cash basis only	37
b. Full accrual basis only	7
c. Both full cash and full accrual	4
d. Cash basis with exceptions	7
e. Accrual basis with exceptions	15
5. Full cash basis used with main exceptions:	
a. Interest on government debt	33
b. Expenditure on fixed assets subject to depreciation	22
6. Full accrual basis used with main exceptions:	
a. Tax receipts	7
b. Capital expenditure treated as ordinary expenditure	4
c. Land and natural resources	4

Discussion Question

- How strong are the internal control systems in your organization?