

AN INTRODUCTION TO PUBLIC FINANCIAL MANAGEMENT

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Public Financial Management (PFM) is concerned with aspects of resource mobilisation and expenditure management in the public sector (for definition of public sector please read ACCA's policy document 'Setting high professional standards for public services around the world' (2012))

Since the private sector lacks the moral sentiment and incentives of a responsible government to provide for various segments of the economy, including the underprivileged, the public sector's role is significant. Expenditure on public services accounts for more than one third of GDP in most countries, hence interest and expectations of these services are high and management of public funds needs to be able to withstand scrutiny from all quarters.

Objectives of public financial management:

In a business enterprise, effective management of finances aids the achievement of business objectives. Similarly, sound public financial management is critical to the achievement of the aims of the public sector through its role in improving the quality of public service outcomes; operational and strategic decision-making; long term sustainability of public services; building public trust in the performance of the sector; and ensuring the efficient and effective use of public funds. Optimal public financial management would additionally display flexibility that allows the targeted sectors to adjust easily and in the desired manner with the public sector induced changes. ACCA has identified four key objectives that effective public financial management should cover:

- aggregate financial management - fiscal sustainability, resource mobilisation and allocation
- operational management - performance, value for money and strategic financial planning and management
- governance - transparency and accountability
- Fiduciary risk management - controls, compliance and oversight (Parry 2010).

Guidance Note on Public Financial Management

1. **Aggregate financial management**

A state normally mobilises its revenue from natural resources under its control, collection of taxes from the public, borrowings, establishment or sale and privatisation of state owned corporations. These resources are then allocated to various public departments in the annual budget according to the priorities that have been identified and agreed upon by the different stakeholders. Public financial management is not only crucial in meeting fiscal aims, monitoring progress against targets and effective utilisation of resources, but a sound system can aid the government in setting future priorities and ensuring fiscal sustainability.

2. **Operational management**

Sound financial management has a direct impact on short and long-term decision-making, performance measurement, strategic planning and management of public services. Some operational aspects that are directly affected through financial management are described as follows.

A) Asset Acquisition & Disposal

Financing capital assets are some of the key decisions in the management of financial resources as they involve significant outflow of resources. In an efficient financial management system, alternative options are explored to finance capital assets in such a way that liquidity is maintained in the successful pursuit of long term objectives. A good governance structure consists of a system of authorisations requiring consent from all the stake holders (or their representatives) before execution of material contracts.

Recent years have witnessed growing interest in alternative means of financing. One in particular namely 'Islamic Finance' has gained prominence in both muslim and non-muslim majority countries. In Pakistan, analysts have recommended that the government should explore a rehabilitation program financed by issuing long term Sukuk (Islamic Bonds) for loss-making state-owned enterprises.

B) Treasury Management

Managing financial resources with the objective of maximising its value involves sufficient risks. In public finance, sound treasury management balances the value maximisation objective of the government with the need to maintain liquidity for the discharge of institutional liabilities. As public funds are at stake, preferred investment opportunities are typically those which are medium to low risk in nature.

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Recent years have been tough on the government of Pakistan, specifically short term liquidity has been a pressing concern. The government owes billions of rupees on account of circular debt. In the fiscal year 2011-12, the government auctioned several treasury bills including Islamic Bonds or *Sukuks* to raise 159 Billion Rupees in order to meet its incumbent commitments. At the end of June 2012, one of the main ingredients of the total domestic debt of Pakistan was Ijara Sukuk. The success and popularity of these (and other Islamic Finance) instruments in Pakistan and abroad may be attributed to the fact that they are backed by tangible assets. In the year 2012, a record \$144 billion worth of new Sukuks were issued worldwide, making them the most popular investment instrument in Islamic banking and finance.

C) Review and Performance Evaluation

Performance evaluation is a critical process for identifying and understanding the mistakes of the past, so as to formulate and implement insightful strategies in the future.

For productive performance evaluation, performance targets and appraisal methods should be—decided inclusively and by consensus within stakeholders to facilitate understanding, monitoring and evaluation of targets and to encourage ownership of shared goals and outcomes. In the public sector, where public services are often provided in partnership with other public, private or third sector entities or where investment by one sector of public services may trigger or cause improvements in the outcomes of another (for e.g. an effective federal vaccination campaign in decreased hospital admissions in an individual district / state without any deployment of resources at local level), performance evaluation of individual public entities becomes all the more challenging.

Insightful performance evaluations may lead to surprising discoveries and revolutionary solutions. As an example, in order to optimize the use of limited public funds, governments can benefit by considering automation and re engineering of processes and by phasing out activities that do not add value.

D) Reporting to stakeholders

An important aspect of financial management, stewardship and the mechanism by which entities meet their financial accountability obligations, is the preparation and publication of annual audited financial statements in entities' annual reports. The purpose of financial statements is to present a true and fair view of an entity's financial performance, position and cash flows. As such, they are an important means of demonstrating how the public sector, both at individual entity and at government level, discharges its financial management responsibilities. Although, both cash and accruals basis accounting is being employed by different countries around the world, in the long term the accruals basis of accounting is preferable to account for public funds as it increases transparency and accountability.

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It is believed that the timely finalisation of an entity's financial statements, accompanied by an unmodified audit opinion, is an important indicator of the effectiveness of an entity's financial management performance. Sound financial management fosters confidence that the entity is using public funds efficiently to provide value for money.

The methods of reporting for public services are continually under debate due to the diverse nature of services provided by the public sector, overlap between services provided by different public sector organisations and the presence of multiple stakeholders. Many believe that since the aim of public entities is to provide services and not to make profits, financial statements can only give limited information about their performance. Innovative methods of reporting (including narrative reporting, scorecards etc.) are being considered to satisfy such diverse audiences and effectively portray public sector performance.

A key debate in the use of such new (and often cumbersome) methods is that the costs and burden of reporting should not outweigh the benefits that are expected to be derived from it. In the Times Higher Education supplement article 'Fidei defensores' dated 8th November 2012, historian Keith Thomas argues that "It is right that in a democratic country the people's representatives should assure themselves that public money is properly spent and that state-funded universities are actively discharging their responsibilities. But the degree of audit and accountability now demanded is excessive, inefficient and hugely wasteful of time and resources".

3. **Governance**

The Audit Commission UK (2009) defined good governance in public services as "ensuring the organisation is doing the right things, in the right way, for the right people, in a timely, inclusive, open, honest and accountable manner".

Good governance assigns the decision making structure to people that can be relied upon for the effective discharge of their responsibility, and this would only be possible when persons with the right set of technical skills and proven capabilities for managing their role have been employed. Decision making provides an opportunity for choosing between available alternatives, hence if an efficient governance structure is established then one can expect that the chosen alternatives would maximise the desired outcomes.

Knowledge of the constitutional environment within which a country operates is crucial to understanding the accountability structures within the public sector. In most jurisdictions/countries, the overall accountability of government organisations to the public is through parliaments or democratically elected representatives. A good public financial management system supports this by providing information which is understandable, accessible and clear and through parliamentary scrutiny of the

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Government's performance. Sound public financial management is inextricably linked with anti-fraud and corruption cultures. An independent internal audit function within a public entity has an integral role to play towards its good governance. It is important that control structures are in place to ascertain whether the allocated financial resources are being utilized for the service of desired outcomes. The public and other stakeholders increasingly expect public entities to bring about improvements in their financial discipline and internal control environments in order to minimise the possibility of fraud and malpractices through improved governance structures.

4. **Fiduciary risk management**

Flexible and intuitive fiduciary risk management is required to mitigate anticipated and unanticipated risks that public entities face while pursuing their objectives. Ongoing monitoring of progress versus goals aids the timely correction of errors and identification of problem areas and future risks.

Public audit from an independent external third party is one of the ways through which the risks that may deter the achievement of desired objectives can be addressed. Public audit is the examination of the records and reports of an enterprise or governmental department by experts or persons other than those responsible for their preparation. Although every transaction cannot be verified by an independent authority, external audits can nonetheless provide reasonable assurance about the governance and discharge of the financial management responsibility by the organisation and that it represents value for money. It can also highlight any shortcomings for management action.

Note:

"The Public Sector Subcommittee of the ACCA Pakistan Members Network Panel is responsible for promoting ACCA research & insights and providing technical advisory on issues affecting the finance profession particularly in the public sector in Pakistan."