DEVELOPING STRATEGIC FINANCIAL MANAGEMENT CONTROL SYSTEMS IN LOCAL GOVERNMENT

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ABSTRACT

To enhance accountability, financial reporting in local government has seen the rise of commercially oriented accounting requirements. There is growing concern that these systems do not meet the needs of local governments for either accountability or internal management. It is internal financial management which should predominate for accountability purposes, not financial reporting. Research suggests there is a lack of strategic orientation in financial management and control systems, and a lack of technical expertise to remedy this. The impact of culture in developing and using these systems has been ignored. This paper suggests a model to examine how culture can be harnessed to improve these systems.

Keywords: Local government, accounting, control systems, culture

INTRODUCTION

In recent years in Australia, accounting regulations have been developed that require the adoption of commercial accounting and reporting practices by public sector organisations. Australian accounting standards specifically relating to the public sector include AAS 27 'Financial reporting by local government'. AAS27, introduced in 1995, is seen as the primary regulatory vehicle which moved local government accounting practices toward private sector accounting practices. The accounting reforms were developed based on the assumption that commercial accounting information is useful for presenting and assessing the accountability and performance of all public-sector organisations (Potter 2002). Whether financial accountability, shown in general purpose accounting reports, is a sufficient discharge of accountability is rarely questioned by the proponents of the use of commercial accounting systems in the public sector. Accountability and performance is assumed to be captured by traditional accounting reports which measure assets, liabilities, equities, revenues and expenses (Potter 2002). Performance indicators developed from these accounting reports have been proposed as a way to enhance accountability (Ryan *et al* 2000).

Financial accountability does not represent the full spectrum of accountability relationships between public sector managers and their stakeholders (Sinclair 1995, Kloot and Martin 2001). Taylor and Rosair (2000) tabulate definitions ranging from explaining actions, providing information about plans and outcomes, setting goals, answering for responsibility, being concerned with probity, and being answerable for producing outputs and using resources. From these multiple perspectives, accounting concepts of accountability are insufficient to assess community outcomes. Kloot and Martin (2000) found that the management control systems in local councils were heavily biased toward financial measures, with little or no measurement relating to outcomes. Kloot and Martin (2000) also found that there was little attempt to manage factors impacting on financial performance such as innovation and learning, and business process renewal. Their financial management and control systems (FMCS) were not strategic in their orientation, nor oriented toward the needs of the community.

FINANCIAL MANAGEMENT VERSUS FINANCIAL REPORTING IN A CONTEXT OF NPM

Many of the premises underlying financial reform in the public sector relate to issues such as reporting, measurement using financial indicators, and auditing of reports (Guthrie *et al* 1999). However, there is little research related to financial management, as opposed to reporting. Internal financial management and control is crucial to ensure that managers are accountable to all stakeholders, and such systems must be developed in a strategic context to ensure accountability to the community's desired outcomes and aspirations. The current focus on accountability in government has changed from accountability to the public at large to accountability for financial outcomes (Naschold and Von Otter 1996). If the accountability pendulum should swing back to a focus on social and equity dimensions of government, then financial management processes which highlight these outcomes may well dominate. Financial accountability is critical in supporting sustainable community outcomes. However, it is internal financial *management* which should dominate, rather than external financial *reporting* slavishly following commercial accounting precepts.

Commercial accounting systems based on accrual accounting concepts have a number of problems when attempting to manage the financial aspects of public sector organisations. For example, the recognition and measurement of non-current physical assets of these organisations is fraught with difficulties. Applying the definition of assets under SAC 4, land under roads and cultural, scientific and heritage collections held publicly are assets. However, the usefulness of attempting to place a value of land under roads, or thousand-year-old artefacts is open to question. Carnegie and Wolznizer (1999) argue that valuing and reporting the collection of public arts institutions does not assist in the financial management and/or accountability of such institutions. Barton (1999) also argues that not only does valuing land under roads distort the financial representation of governments, it hinders road management.

The adoption of commercial accounting practices in the public sector is consistent with the adoption of business-like management techniques and styles by government over the last fifteen years - the New Public Management (NPM). While some observers attribute much of the failure of traditional public sector bureaucracies to their accounting information systems (Osborne and Gaebler 1993, Lapsley 1999) we question the validity of applying commercially oriented systems in the public sector. A number of writers also suggest that a concentration on financial accounting and financial costs in NPM does not result in enhanced performance, and may, in fact, be injurious (see Hood 1995 for a good summary). Such a concentration may lead to outcomes not always those intended by central government (Seal 1999).

The rhetoric of NPM includes a focus on performance, which in more recent times has emphasised performance relating to outcomes and has driven thinking about public sector reform well beyond debates about public or private vehicles for delivery of government services. NPM is often interpreted as a response to fiscal stress and a resistance by the community to extra taxes (Hood 1995, Van Helden 2000). It could therefore be expected to focus on the community and the specification of performance outcomes. However, the use of performance outcomes as a strategic planning device, one which is reflected in the FMCS, is not commonly found in local government performance management systems (Kloot and Martin 2001). NPM focuses on performance outputs (numbers of services), input efficiencies (resources used) and associated parsimony in resource use and private sector management practices (Hood 1995). However, there is little emphasis placed on outcomes (stakeholder perceptions of results that matter). While the drive for more outcomes-oriented public sector management is a characteristic of Australian local government reform rhetoric (Kloot 2001) the development of strategic, outcomes-focused performance measurement and management systems for local government has not occurred (Kloot and Martin 2000). To date, there has been no empirical research on strategic performance measures which enable local governments to determine the impact of their efforts on the day-to-day lives of individuals and the local community. While state governments are implementing policy initiatives to reflect this, such as the Victorian Bracks Labour Government's 'Best Value' (implemented 1999), there has been no evaluation of the impact of these changes.

Outcome measures for the public sector have not been developed to the same extent as have been input and output measures (Kloot 1999). Kloot and Martin (2000) confirmed that local governments do not measure outcomes in any systematic and comprehensive manner. Those outcome measures that have been identified are typically wide ranging in their nature. An example is the World Bank's four outcome dimensions for its City Development Strategy : liveability, competitiveness, good management and governance, and bankability, albeit measures more relevant to the Bank's interests than the interests of local communities (World Bank 2000).

The pre-occupation with Kaplan and Norton's (1992, 1996) 'balanced scorecard' concept in local government (Quinlivan 2000) reflects the interest in performance outcomes at this level of government. Kloot and Martin (2000) used this framework to develop a comprehensive model of strategic performance management in Australian local government. This model incorporates the use of strategic FMCS in managing organisational performance. This model, and similar models such as Atkinson and McCrindell (1997) and Fitzgerald *et al* (1991), incorporates strategic community outcomes into the performance management system.

AUSTRALIAN LOCAL GOVERNMENT

This paper is particularly concerned with the Australian local government sector . Local government is an important arm of Australian government. It spends $13 billion annually, or approximately 6% of total public sector expenditure. It delivers a wide range of community services, develops and maintains essential infrastructure, and has a direct and significant impact on local economic development. In the context of public sector reform worldwide, Australian local government has experienced considerable reform and change (Kloot and Goodwin 1997, Martin 1999). Research (Kloot 1999, Kluvers 2001) has indicated that FMCS lack robustness in local government. There is recent research into the role of program budgeting in financial control in Victorian local government (Kluvers 2001), and the use of annual reports to demonstrate accountability in Queensland local government (Ryan *et al* 2000). However, there has been limited research across Australia on the use and impact of strategic financial management and control systems in local government.

NPM, heightened awareness of accountability and developments in private sector management have been around for almost a decade. Why then are FMCS so underdeveloped in local government? There are two factors impacting on the state of FMCS in the sector. The first is related to technical expertise, the second to organisational culture and change issues.

TECHNICAL EXPERTISE AND THE DEVELOPMENT OF FMCS

Victoria, the Australian state that restructured and reformed its system of local government in the 1990s more radically than any other state, still has much to do to improve local government FMCS such that they are valid and reliable sources of information on council performance. The Institute of Chartered Accountants of Australia (2001) recently undertook a survey of Victorian local government budgets, one essential element of a council's financial management and control system. The ICAA concluded in its damming report that the quality and content of Victorian council budgets is variable but generally poor, indicating that the sector has not effectively embraced the notion of accountability. Financial projections are based on out dated methods which incorporate revenue and expenditure measurement techniques which do not comply with generally accepted accounting principles and are therefore inconsistent with annual financial reporting;

The ICAA's assessment suggests that reforms have been misguided, or poorly implemented, or a combination of these and other factors. The implications of these findings, in a supposedly leading local government system, for the financial management practices of local governments in other states should be of concern to state governments, the level of government in the Australian federal system with legal responsibility for local government.

Previous research points to a lack of technical accounting and finance expertise in Australian local government (e.g Kloot et al 1999). However, lack of technical expertise should be able to be overcome. Appropriate management accounting technologies which exist in the private sector can be transferred to the public sector with relative ease. Strategies to address the lack of technical expertise may include greater focus on education and training, a role for the professional associations in practitioner development, celebration of best practice through industry innovation awards, contracting in of appropriate staff, and consultants to assist with the implementation of these and related strategies. For example, a number of private sector consultants offer to develop and install balanced scorecard system and/or ABC costing systems within short time frames.

The fact that the lack of expertise continues despite such strategies being widely available points to a deeper problem. We contend that the problem is related to organisational culture. Previous research (Kloot and Martin 2000, Kloot et al 1999) has noted local government cultures in which the view that local government is different and therefore cannot learn from private sector technologies persists at all levels of management. Why this view persists and how it can be overcome is, we contend, related to mental models and existing logics of action: the expression of culture.

ORGANISATIONAL CULTURE AND FMCS

In their research on the application of the balanced scorecard in local government, Kloot and Martin (2000) concluded that the issue of corporate culture is crucial in local government performance management. Goddard (1999) attempted to identify the historical, political and organisational factors which determine the nature of a local government's FMCS. He raised a number of questions about the development and function of FMCS. What is the degree of formalisation? How centralised is the FMCS? Where is the location of financial expertise in the organisation? How does the system operate, and how do managers interact with it? And, how devolved is the budgeting responsibility down through the organisation? His research makes the important connection between organisational culture and the nature of the local government's FMCS. Similarly Cuervo (2000) argued that the often observed negative gap between projected performance and actual performance in privatised public entities could be explained by organisational and contextual variables including culture and strategy. The challenge for accountants is to develop financial and management control systems that will work given the local culture and are consistent with appropriate business practices to ensure that there is little or no gap between actual and planned outcomes.

There is a large body of work relating to the impact of historical events shaping organisational culture (Hofstede 1980, Frost 1985, Schein 1985, Trompenaars & Hampden-Turner 1997). The recent work of Goddard (1999) focuses on the relationship between organisational culture and FMCS in local government. In his research into the role of culture on FMCS, Goddard highlights key concepts from the organisation culture literature. He cites Rosen (1991) who notes that 'corporate culture is about meaning and its construction, about ideas, values, beliefs and assumptions.' We are interested in the construction of meaning in local government organisations as it relates to the nature and role of FMCS, especially as it reflects outcomes oriented performance management information.

Goddard adopts Whipp *et al's* (1989) framework for analysing culture. This framework views culture as a set of core beliefs and four modes of expression: logics of action, language, myths and metaphors, and patterns of status and reward. The latter are influenced by the characteristics of the FMCS, and conversely influence the FMCS. The connection between (1) the use of private sector financially oriented language and (2) a local government's performance orientation can be analysed by studying the culture of local government organisations.

Goddard's model suggests that local governments that impose commercially oriented financial reporting systems without consideration of the organisation's culture and its different types of accountabilities will experience considerable difficulty implementing such systems. If FMCS are to provide strategic direction in local governments during periods of turbulence and change, employees will need to both understand the basis of such systems, and be committed to their application and use. In his review of local government's response to amalgamation and the use of the private sector for service delivery, imposed on Victorian local government in the mid 1990s, Martin (1999) concluded that three factors contributed to high levels of employee commitment: CEO leadership, effective communication about change, and a clear understanding of the performance outcomes of these new arrangements.

A culture that includes high levels of commitment to accountability for community outcomes is necessary for the development and implementation of strategically based FMCS. Kloot and Martin (2000, 2001) have found that high levels of accountability are characteristic of local governments with a strong culture of employee engagement and involvement in service delivery. This includes the design and operation of FMCS. The availability of commercially oriented and technically correct FMCS is not in itself sufficient to guarantee the appropriate use of such systems for internal management and control, nor is the imposition of financial reporting standards purported to enhance accountability for community outcomes. Without high levels of employee understanding and commitment, commercially oriented FMCS introduced into the organisation run the risk of being seen as externally imposed and of little relevance for employees in achieving community outcomes.

FUTURE DIRECTIONS: RESEARCHING ORGANISATION CULTURE AND FMCS

The question of why external reporting has not lead to more effective outcomes needs to be answered if local government FMCS are to be improved. Research into cultural characteristics will highlight the importance of these factors on the effective implementation of commercially oriented FMCS. Cultural characteristics may explain why employees who want to be held accountable see little connection between external reporting requirements designed to enhance accountability, and their needs for internal management systems designed to improve community outcomes.

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