

# Financial Management or Accounting: A Theoretical Analysis of the Benefits and Limitations of Developing a 'True' Financial Management Approach within Government Agencies in Australia

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## Abstract

Government financial management has long focused on accountability and transparency as a means of demonstrating the efficient and responsible use of taxpayer funds. Within Australian Government agencies, financial management practices have become increasingly efficient and effective in communicating financial information through financial statements and reports. However, there is considerable anecdotal evidence to suggest that such practices are more appropriately defined as accounting, rather than as financial management. This paper discusses the practices that are currently used by Government agencies, the limitations of this approach, and provides a theoretical look at the potential benefits that financial management approaches provide to Government agencies.

**Keywords:** Financial; Management; Accounting; Government

## Introduction

Government financial management systems are crucial for ensuring accountable and transparent use of taxpayer funds [1]. Over the past twenty years, there have been numerous reforms in Government financial management systems [2], and there is now general agreement that these systems have improved to the extent that they provide more meaningful information to the community [3], greater transparency and efficiency [4], and enhanced ability to identify errors or concealed information [5].

Despite this, Government financial management has been criticised widely because of inadequate dissemination [6], use of broad and immeasurable performance outcomes [7], failure to generate meaningful information for management decisions [4], insufficient monitoring/evaluation [2], and ineffective data [8]. Moreover, it has been argued that the focus should shift from present analysis to future predictions [9].

These criticisms may, in part, be explained by differences between accounting and financial management disciplines. Where accounting is focused on reporting and compliance, financial management is focused on cash flows and decision-making [10]. Consequently, accounting is concerned with the past, while financial management is focused on the present and future [11]. Anecdotal evidence therefore suggests that existing financial systems in Government are based on accounting, rather than financial management.

This paper discusses the existing financial approach used by Government agencies in Australia, with specific focus on the Northern Territory Government and the limitations that are imposed on these agencies as a result of this system. The paper then theorises about the potential benefits and limitations should a 'true' financial management approach be adopted by individual Government agencies.

## Current Arrangements: Accounting or Financial Management?

It is necessary to briefly outline the system that is generally used by Government organisations in Australia. In general, each agency (as well as Government Business Units and publically-owned corporations) are assigned an annual appropriation (determined by

Cabinet). This funding is generated through an external corporation, which is responsible for all investing and borrowing activities on behalf of Cabinet (Figure 1).

Individual agencies, therefore, are not responsible for investment or dividend decisions, and are only responsible for small-scale financing decisions in relation to purchase of capital items. Instead, the Chief Financial Officer ('CFO') advises the CEO in relation to legislative compliance, accountability, internal controls and audits, and accuracy and transparency of financial and budgetary information, but has lesser involvement in decision-making, forecasting, and risk assessment. Instead, decisions are made by an Executive Management Team, based on financial, political, social, environmental, strategic, and reputational information.

Collectively, this research suggests that the focus of Government agencies is on accounting rather than financial management.

## Limitations of the Current System

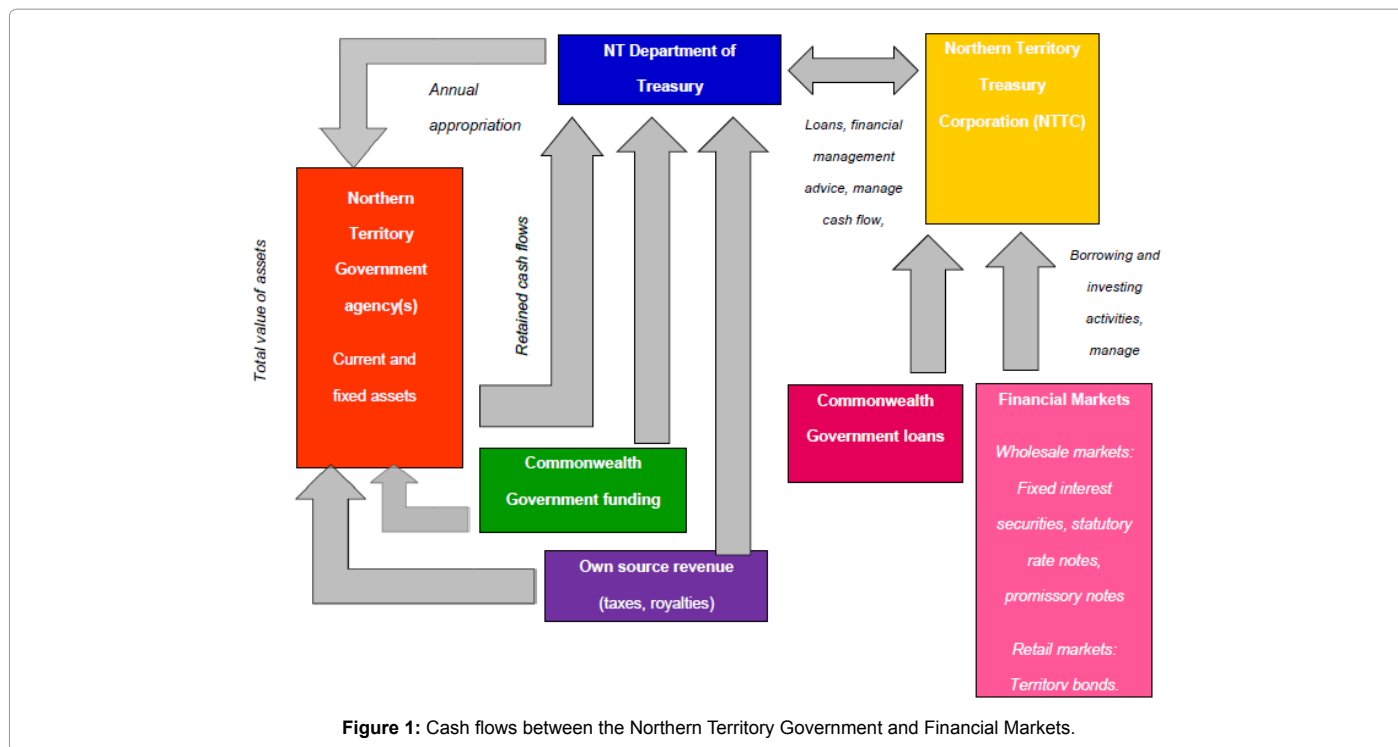
Under the current system, agencies are allocated an annual appropriation and any cash flows that are generated through business are returned to the Department of Treasury ('Treasury'). This creates a disincentive for agencies to generate their own cash flows through permits, entry fees, fee-for-service arrangements, fines, investments, or other revenue-raising opportunities. The capacity to retain revenue would not only empower the organisation to generate more cash flow, but it would also provide the agency with an opportunity to fund other projects/programs that might otherwise remain unfunded.

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Additionally, this approach would increase efficiencies, since agencies would seek to enhance profitability of enterprises and develop innovative and creative approaches to generate greater 'bang-for-buck'.

Further, at the end of financial year, agencies spend remaining budget on items or works that were not a priority previously and would not have been funded otherwise. This occurs because there is no incentive for agencies to make savings since any retained cash flows are returned to Treasury. This differs from private enterprise, where businesses seek to make savings or generate cash flows for disbursement to shareholders through dividends or for new growth opportunities [12].

Additionally, the annual funding cycle coupled with the three-to-four year political cycle almost compels agencies to focus on the short-term, despite the need for five or ten year strategic plans to meet management and operational obligations [13]. Without assurance of funds beyond 12-months, agencies tend to focus on delivering short-term outcomes with little need for forecasting [14]. This is contrary to the principles of financial management, which focuses on determining the value of future cash flows, identifying opportunities for future returns, predicting and forecasting present and future events on investments, evaluating cost of capital, and assessing current and future risk [12].

Thus, the existing financial system fails to encourage agencies to deliver savings, to plan for the future, to consider the efficient use of funds in the long-term, or to generate new cash flows [15]. While the approach is both transparent and accountable as required under legislation, it doesn't allow for 'true' financial management to be adopted.

### Adopting 'True' Financial Management Practices within Government Agencies

Current practices in the public sector in relation to financial

reporting, administration, and allocation and use of funds are governed by legislation. For this reason, altering the current structure would be complex and problematic. Theoretically, however, it is interesting to consider the possible outcomes that could be achieved if individual agencies were to focus on 'true' financial management, rather than accounting practices.

In the Northern Territory, the Northern Territory Treasury Corporation (NTTC) uses two avenues for generating funds – wholesale and retail markets. In both cases, the primary borrowing instrument is bond. While bonds are frequently used by governments, bonds can be less flexible than other approaches. Smaller Government agencies, dealing with considerably less capital, might be able to access alternative financing approaches to generate sufficient capital for operations. For instance, the Parks and Wildlife Commission might attempt to access philanthropic monies, green bonds, social enterprise loans, crowd funding or microloans (Table 1). These investment approaches would either not be suitable for the NTTC or would not generate the level of funds that would be required for the entire NT Government. Other Government agencies are also likely to be able to access unique financing opportunities specific to their industry (e.g., health, community services, education, sport and recreation, etc.). While agencies would still rely on the annual appropriation from the NTTC, this approach would enable these organisations to better utilise this appropriation in the long-term.

A further benefit of financial management is the significant potential for private-public partnerships, since private enterprise could profit from shared capital investments in infrastructure and other projects, generating greater public value. This would see a considerable change in the nature of relationships with private enterprise, from contractors (paid by Government) to partners and investors.

The primary concern with adopting this approach is the potential implications for the agency and the Northern Territory Government should an agency make poor investment decisions. Such decisions

Hedge funds	A private investment made up of pooled funds, often formed under a proprietary partnership, which invest funds using credit or borrowed capital. These funds aim to make high returns.	<a href="https://en.wikipedia.org/wiki/Social_enterprise_lending">https://en.wikipedia.org/wiki/Social_enterprise_lending</a>
Crowd funding	This is the practice in which projects are funded through separate investments from a large number of different people, typically through the internet.	<a href="https://en.wikipedia.org/wiki/Crowdfunding">https://en.wikipedia.org/wiki/Crowdfunding</a>
Commercial bank secured loan	This is essentially a loan which is secured through another asset such that default on the loan or bankruptcy will allow the bank to claim before any other interested party.	<a href="http://www.investopedia.com/terms/s/senior-bank-loan.asp">http://www.investopedia.com/terms/s/senior-bank-loan.asp</a>
Philanthropic capital	Funds that can be secured through individual investors for social or environmental benefits without expectation of a return or repayment.	<a href="http://knowhownonprofit.org/funding/social-investment-1/investment-types/philanthropic-capital">http://knowhownonprofit.org/funding/social-investment-1/investment-types/philanthropic-capital</a>
Charitable bonds	These are bonds that are issued by charities and not-for-profit organisations to secure capital. This may not be accessible to agencies, but may be accessible to Government Business Units.	<a href="http://knowhownonprofit.org/funding/social-investment-1/investment-types/charitable-bonds">http://knowhownonprofit.org/funding/social-investment-1/investment-types/charitable-bonds</a>
Venture philanthropy	Loans and other support is provided to socially motivated organisations (including charities, social enterprises or socially driven commercial businesses).	<a href="https://webgate.ec.europa.eu/socialinnovationeurope/en/magazine/finance/articles-reports/venture-philanthropy-defined">https://webgate.ec.europa.eu/socialinnovationeurope/en/magazine/finance/articles-reports/venture-philanthropy-defined</a>
Green bonds	These are tax-exempt bonds that are issued by qualified organisations and whose proceeds fund environmentally significant projects.	<a href="http://bonds.about.com/od/munibonds/a/What-Are-Green-Bonds.htm">http://bonds.about.com/od/munibonds/a/What-Are-Green-Bonds.htm</a>
Microloans	These are small (usually less than \$25000), short-term loans that assist in purchasing capital and other equipment. They cannot be used to pay off existing debts.	<a href="http://www.entrepreneur.com/encyclopedia/microloan">http://www.entrepreneur.com/encyclopedia/microloan</a>
Social enterprise loans	These are financing avenues for organisations with goals to social organisations or organisations seeking positive social outcomes. They are offered at below market rates. Often capital and interest payments are not due until the project is profitable.	<a href="https://en.wikipedia.org/wiki/Social_enterprise_lending">https://en.wikipedia.org/wiki/Social_enterprise_lending</a>

**Table 1:** Potential financing approaches that could be explored by individual Government agencies under an alternative financial management approach.

could result in loss of funds, reputation, and an inability to deliver critical services. Given the risk adverse nature of Government, it is likely that this risk alone would prevent Government from pursuing true financial management.

A second drawback is the political cycle and the influence that Cabinet and the Minister's wish to have on an agency's budget. It is likely that even if this approach was pursued, constraints would be placed on the term with which investments could be made (i.e., three to four years), potentially limiting the value of this approach both in terms of the financing that can be accessed and the medium- and long-term strategies/plans of the agency.

## Conclusion

Governments are focused on ensuring the accountable and transparent use of taxpayer funds. Therefore, the focus of agencies tends to be on accurate accounting processes, rather than on financial management. While this approach ensures conformity with legislation, it can lead to inefficient expenditure of funds, poor decision-making, apathetic approaches to generating alternative funds, and a focus on short-term deliverables. This is in contrast with the private sector, which seeks to generate savings for new investments or to fund dividends while also capitalising on every financial opportunity that is presented.

The structure of most Government organisations is that there is a central corporation which is responsible for the all investing and financing activities on behalf of all agencies. Capital generated through this corporation provides each agency with an annual appropriation. While there is some scope for agencies to generate additional funds, any additional capital is retained by Treasury, creating disincentives for agencies to develop new business or to retain unspent cash flows at the end of financial year.

Financial management provides an alternative approach for Governments to empower individual agencies to:

- Generate cash flows through a variety of different and novel financing approaches;

- Predict and forecast future events and act to generate capital as a result of these events;
- Create savings;
- Develop medium- and long-term strategies to support agency visions and plans; and
- Improve operating efficiency and performance.

However, as Mikesell and Mullins [3] and Richardson [16] highlight, politics frequently presents a significant barrier to effective financial processes. While Government agencies may benefit from financial management, it is likely that political and reputational consequences of poor financial management practices, coupled with political cycles and influences, are likely to be more important than the benefits that might be provided through financial management.

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