The Auditor-General
Audit Report No.52 2001–2002
Financial Control and Administration Audit

Internal Budgeting

Australian National Audit Office

ISSN 1036–7632

ISBN 0 642 80640 3

Canberra ACT
24 May 2002

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken an across agency Financial Control and Administration audit in accordance with the authority contained in the *Auditor-General Act 1997.* I present this report of this audit, and the accompanying brochure, to the Parliament. The report is titled *Internal Budgeting.*

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage—http://www.anao.gov.au.

Yours sincerely

P. J. Barrett
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

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Summary and Recommendations

Summary

Background

1. Budgeting processes within organisations in the Australian Public Sector (APS) are relevant across two broad, yet complementary dimensions. The first dimension is the Commonwealth budget process, which, amongst other things, draws together the Commonwealth Government's estimates of expenses and revenues for the budget year. The second dimension relates to those budgeting processes which form part of each organisation's internal financial management framework, and which are critical for effective business planning, resource allocation and the management of performance. This audit focussed on internal budget processes in the latter dimension.

2. From 1999–2000, organisations in the APS have budgeted, operated and reported under the accruals-based, outputs and outcomes framework. This framework is designed to enhance the performance and public accountability of the APS by driving improvement in the way organisations manage their resources and the way they measure their results.[1] In addition to changing the overall financial management environment in which the Parliament authorises appropriation funds, the new framework has also required individual organisations to adopt more business-like financial management practices. Improved financial management practice is critical, as organisations are increasingly expected to deliver government outcomes more efficiently and effectively.

Audit objectives and focus

3. The objective of the audit was to evaluate the efficiency and effectiveness of internal budget processes in view of their contribution to business planning, resource allocation decisions and the management of financial performance. The audit also assessed whether organisations had revised their approaches to internal budgeting to reflect the introduction of the new framework.

4. The audit, which focussed on processes associated with the 2000–2001 internal budget was undertaken in two phases. The first phase involved a survey being issued to 50 organisations to obtain information on:

- the costs, resources and time involved in the preparation of the internal budget;

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[1] More information on the Commonwealth budget and the accrual-based, outputs and outcomes framework can be obtained from <www.finance.gov.au>.

- processes used in the preparation of the internal budget; and
- processes for the revision of internal budgets.

5. The second phase of the audit involved the conduct of detailed fieldwork in eight of the organisations that participated and responded to the survey. The audit evaluated processes against four broad audit criteria. Within each audit criteria, more detailed evaluation criteria were developed using material gathered from research into APS and international sources.

6. The audit criteria were as follows:

- Framework—internal budgeting should play a key role in the organisation's financial management framework and be closely aligned with business planning.
- Preparedness—the impact of the new accrual-based, output management framework should have been assessed and the organisation's staff prepared so they can operate effectively.
- Development and revision—procedures for the development and revision of internal budgets were efficient and effective.
- Monitoring and review—information on performance against internal budgets was regularly monitored and this information is used to assist in decision-making and the management of the organisation.

Audit conclusion

7. Most organisations reviewed had sound and well-established processes for the development of internal budgets. In those organisations, the development of the internal budget was closely integrated with business planning processes, ensuring that the determination and allocation of resources were based on operational needs and consistent with approved strategies and priorities.

8. The audit also observed a number of shortcomings in the ongoing management of internal budgets. These shortcomings tended to reduce the effectiveness of the contribution of internal budgeting to the overall internal financial management and control environment. For example, while each organisation required line managers to regularly analyse their financial performance, including monitoring performance against approved internal budgets, not all the organisations ensured these processes were completed accurately or consistently. Further, not all the organisations incorporated the results of these assessments into the consolidated (organisation-wide) financial management performance reports provided to senior management.

9. Careful consideration of potential improvements is important, as the adoption of more robust and business-like practices is essential to the successful implementation of the new financial management and budgeting framework. In this regard, the key areas identified during the audit, which require continued focus by organisations are:

- acquiring (and/or developing) and retaining personnel skilled in budgeting, decision-making and financial management in an accrual-based environment;
- continued involvement of operational or line managers in budget and financial management matters, including for example, the need to manage effectively accrual-based information throughout the organisation;
- clarity and increased understanding of budget management responsibilities, through for example, inclusion of targets in performance agreements;
- involvement and support from senior management for the adoption of new budget and financial management practices; and
- developing the functionality of accrual-capable Financial Management Information Systems (FMIS), or implementing specialised budgeting and reporting tools which facilitate the development of the internal budget and provide timely financial and management information throughout the organisation.[2]

Audit findings

Framework

10. The framework in which the internal budget is prepared was considered sound in most of the organisations audited. In seven of the eight organisations audited, the development of the internal budget was closely linked to corporate or business planning. Accordingly, organisations were able to be confident that the allocation of resources aligned with objectives, strategies and priorities. Another important factor in a sound framework is the involvement and support of senior management. Senior managers were actively involved in the internal budget process in most of the organisations audited, although only two organisations had designated a committee to specifically deal with the management of internal budget issues.

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2 For more information on the use of FMISs refer to ANAO Audit Report No.12 2001–2002, *Selection, Implementation and Management of Financial Management Information Systems in Commonwealth Agencies.*

11. A critical area for improvement related to the need for clear enunciation and communication of internal budget management responsibilities. The audit found that uncertainty and misunderstanding about budget items tended to exist when these responsibilities were not clearly defined or articulated. This situation also tended to reduce the level of ownership and commitment to internal budgets.

Preparedness

12. Several shortcomings in their level of preparedness for the adoption of the new financial management and budgeting framework were observed in the organisations reviewed. Most significantly, only three organisations had formally completed a re-assessment of the financial information needs of managers in this new financial management environment. Further, only three organisations had developed organisation-specific training to provide practical information on the implementation of new financial management practices in their environment.

13. Amongst those organisations which moved to this new framework in 1999–2000, the audit found that accrual-based financial management practices are often the domain of central finance sections and had not been widely adopted by operational or line managers. While there was a high level of appreciation of outputs, many line managers indicated they have no or little concern for accrual-based information and remain focussed on cash-expenditure issues. This situation increases the risk of a further separation of financial management practices developing amongst budget managers and, in some organisations, has resulted in the development of separate reporting processes for cash and accrual-based financial information.

14. Those organisations subject to audit, which have operated in an accrual environment for many years, indicated that the successful integration of accrual-based information and the associated changes to financial management practices entail considerable investment of time and support. However, this effort results in better management of budgets and resources.

Budget development and revision

15. The audit found that budget development and revision processes employed by the organisations audited were largely efficient and effective. The criteria used to assess the effectiveness of budget preparation processes were either partly, or fully demonstrated, by most of the organisations audited. The more efficient budget development processes were characterised by high degrees of coordination, consistency of practices (particularly in situations of devolved budget development responsibility) and clarity in the communication of information to budget preparers. Another common feature of the more efficient processes was a high level of involvement in the development process by senior management.

16. The main areas, where scope for further improvement was identified, were in relation to the low rate of use of specialised budget management software which is properly integrated or interfaced with the FMIS, and instances of insufficient documentation of the reasons or justification for revisions to approved internal budgets.

Monitoring and review

17. The audit identified a number of opportunities to enhance the efficiency and effectiveness of financial performance monitoring processes, including the need for organisations to implement more robust and corporately managed reporting capabilities. While in each of the organisations audited, managers regularly monitored financial performance, only a few had an effective financial performance management framework in place.

18. Improvements in the reporting capabilities of the FMIS or other corporately managed systems are required to reduce the need for subsidiary applications to re-format, or in some cases, supplement the financial information available from these systems. By implementing improvements, organisations can access savings in time and costs and reduce the risk of erroneous, 'non-corporate' data inadvertently being used by managers. In addition, those organisations that primarily rely on information from the FMIS, or other corporately managed systems consistently report more reliable budget performance information to management. Finally, the effectiveness of the accountability chain can be increased by ensuring, as part of the assessment of financial performance, that there is formal communication and an exchange of information and analysis between line and senior management.

Sound and better practices

19. The audit identified a number of examples of sound and better practices in the organisations reviewed. A summary of these is provided in Table 1.

Table 1

Sound and better practices

Framework
Discussions and liaison with key external stakeholders formed an important part of strategic and business planning, including internal budgeting processes.
The development of internal budgets was closely integrated with corporate and business planning processes.
Budget preparation and management responsibilities were clearly identified in policy and procedural documentation and in individual performance agreements.
A senior management committee was established to oversee the development of the internal budget.
Preparedness
Internal budget items were aligned to the organisation's outputs in the FMIS.
Organisation-specific training was provided on the operational impacts of the new accrual-based, output management framework, including information on accrual accounting, resource and performance management and decision-making.
Line managers, supported by sufficient reporting functionality within the FMIS are responsible for defining and meeting their financial information needs.
Development and revision
Information on the development of the internal budget, including policies, guidelines and templates were readily available through an intranet.
The internal budget is developed using a zero or priority-based model which ensures that the allocation of resources was based on pre-defined criteria and objective parameters.
The internal budget is developed utilising the FMIS or corporately managed specialised budget management software, interfaced with the FMIS.
Detailed internal budget preparation instructions explaining, amongst other things, key assumptions and imperatives, methodology, timetable and information requirements are provided to budget preparers each year.

Monitoring and review
Comprehensive financial reports, providing details of actual performance against forecasts and budgets are available from the FMIS to line managers within three days of the close of each period.
The results of the analysis of financial performance by line managers are summarised and incorporated into the management reports provided to senior management.
Senior managers are provided with reports incorporating financial and non-financial ratios and performance indicators.
Line managers are able to access real-time financial information, through ad-hoc inquiries, from the FMIS.
Line managers are required to certify as to the accuracy and completeness of their monthly financial accounts and provide explanations for any variances from forecasts above minimum thresholds.

Recommendations

The nature of the issues raised in this report are considered to have general applicability across the Commonwealth Public Sector. Accordingly, the following recommendations should be addressed by all Commonwealth organisations in the context of improving their financial management and internal budgeting frameworks.

Organisations should assess the benefits of implementing each recommendation in light of their own circumstances, including the extent to which each recommendation, or part thereof, may already have been adopted.

Recommendation No. 1
Managers' responsibilities (paragraph 2.24)

To improve accountability for internal budget outcomes and enhance the effectiveness of financial management, it is ***recommended*** that organisations ensure internal budget management responsibilities are clearly articulated and communicated through one or more of:

- approved internal budgeting or business planning policy / procedural documentation;
- business plans or individual work area action plans; and / or
- responsible managers' performance agreements.

Recommendation No. 2
Operating in an accrual-based environment (paragraphs 2.45–2.46)

To encourage further improvements in financial management practice, which is necessary for the successful implementation of the new accrual-based, output and outcomes management framework, it is ***recommended*** that organisations:

- assess the benefits, in terms of enhanced financial management and accountability, of devolving financial responsibility to line managers for the full accrual-cost of the resources they control; and
- reassess the financial information needs of managers based on their financial management responsibilities.

Recommendation No. 3
Measuring budget development performance (paragraphs 2.94–2.96)

To assist with the identification and diagnosis of process weaknesses, and to secure potential time and cost savings through the adoption of improved practices, it is ***recommended*** that organisations periodically measure the efficiency and effectiveness of their internal budget development processes against appropriate external references or benchmarks.

Recommendation No. 4 Financial reporting (paragraphs 2.122–2.123)

To identify opportunities for greater efficiency and effectiveness in the management of financial performance, it is ***recommended*** that organisations reassess whether their FMIS continues to be capable of providing financial information in a manner and format sufficient to satisfy the needs of their managers in the new accrual-based, output and outcomes management framework.

Recommendation No. 5 Financial performance analysis (paragraph 2.124)

Since comprehensive analysis and review are fundamental to the effective management of performance and through improved communication, greater levels of understanding and more consistent financial performance outcomes are achieved, it is ***recommended*** that organisations ensure:

- financial management reports provided to senior management include the details of, or a commentary on, the results of any analysis and review of financial performance undertaken by operational or line managers; and
- any matters of significance arising from senior managements' assessment of financial performance, including details of decisions, should be referred to operational or line managers for advice or action in a timely manner.

Audit Findings and Conclusions

1. Introduction

Accrual-based, outcomes and output framework

1.1 All Commonwealth agencies are now required to plan and report on the basis of the Commonwealth's accrual-based, outcomes and outputs framework. This framework aims to change both 'what' (outcomes and outputs) and 'how' (accrual-based) the work of government agencies is measured. The framework emphasises links between funding and results and closer integration of planning, measurement and reporting of results.[3]

1.2 Accrual-based budgeting and reporting is an essential part of this new framework as it provides the best measure of the cost of services or outputs produced across longer periods of time. In particular, the use of accrual-based information focuses managers' attention to three key areas of financial management:

- full cost of operations: under the new framework organisations are expected to manage all of their resources, not only cash. This includes, for example, the emerging costs of staff (that is, leave entitlement liabilities) and the cost of using or consuming assets (that is, depreciation). Understanding these costs assists in ensuring the most efficient price for the outputs produced;
- balance sheet management: distinguishing between operating and capital transactions enables greater focus on, and separate analysis of asset and debt (liability) management. This information enables better assessments of the sustainability of operations and the appropriate level of investment in assets over time; and
- cash flow management: the new framework requires continued focus on the management of cash-related items (including debtors and creditors) to improve the use of cash and the maximisation of cash resources. In conjunction with improved balance sheet management this provides better linkage between available cash resources and the future requirements of the organisation.

[3] *The Outcomes & Outputs Framework*, Department of Finance and Administration, which is available at <www.finance.gov.au>.

Internal budgeting

1.3 A robust internal budgeting process is essential to effective financial management and the successful implementation of this new framework, by providing a means of improved resource allocation and the management of financial performance.

1.4 Effective internal budgeting, which should be closely integrated with business planning processes, requires a comprehensive and collaborative approach, involving input and support from throughout the organisation. Effective internal budgeting can make a valuable contribution to the attainment of an organisation's objectives by:

- communicating and improving understanding of the priorities of the organisation;
- identifying financial risk to the attainment of the organisation's objectives;
- supporting an accurate and informed allocation of resources;
- providing accurate and timely financial and performance information to support decision-making and the measurement of performance; and
- providing a means of identifying and responding to, changes in business and environmental conditions.

1.5 Effective planning, budgeting, monitoring and reporting processes are also an important part of a robust and credible control environment.[4]

Scope of the audit

1.6 The audit was designed to evaluate whether internal budgeting was an effective part of each organisation's financial management processes, in particular, whether it effectively contributes to business planning and control decisions, resource allocation processes and the monitoring and management of performance.

1.7 The audit did not consider those processes associated with the preparation of budget estimates for, nor each organisation's participation in, the Commonwealth budget process. The Commonwealth budget process draws together the Commonwealth Government's estimates of expenses and revenues for the budget year and authorises the quantum of funds for appropriation to public sector organisations from the Commonwealth Treasury.[5]

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4 *Controlling Performance and Outcomes—Better Practice Guide to Effective Control Structures*, Australian National Audit Office, Commonwealth of Australia, 1997.

5 The quality of, and extent of controls over, budget estimates were evaluated in ANAO Audit Report No.38 1998–99, *The Management of Commonwealth Budgetary Processes.*

Audit objectives and approach

1.8 The objective of the audit was to evaluate the efficiency and effectiveness of internal budget processes in view of their contribution to business planning, resource allocation decisions and the management of financial performance. The audit also assessed whether organisations had revised their approaches to internal budgeting to reflect the introduction of the new framework.

1.9 The audit was undertaken in the following broad phases:

- *Survey*—a survey was issued to 50 organisations to obtain information on the resources involved in, and the practices associated with, preparing and revising the 2000–2001 budget. Forty-eight organisations provided responses to questions concerning the nature of the development and revision processes and 45 organisations provided responses to questions concerning the level of resources involved in the internal budget process.
- *Fieldwork*—detailed fieldwork was undertaken in eight of the organisations, which participated in the survey. Fieldwork involved obtaining a more detailed understanding of each organisation's internal budgeting policies and processes, confirming the reasonableness of the survey responses and confirming the application of the organisation's internal budgeting policies and processes in line or operational areas.

1.10 To assist in the analysis of results, the organisations involved in the audit were stratified into small, medium or large categories according to the parameters shown in Table 2.

Table 2

	Small	Medium	Large
Level of departmental expenditure	less than $50 million	between $50 million and $200 million	over $200 million
Number of geographic locations	between 1 and 5	between 6 and 20	over 20
Number of staff	less than 300	between 300 and 1000	over 1000

1.11 The audit reviewed internal budget processes relating to *'Agency'* or *'Departmental'* items, that is, revenues earned in the delivery of the organisation's outputs and expenses incurred in the course of producing those outputs. The audit did not consider *'Administered'* items, which the organisation manages or administers on behalf of the Commonwealth but which it does not control.

Audit criteria

1.12 Details of the audit criteria and the evaluation criteria used in the audit are in Table 3.

Table 3
Audit criteria

Audit criteria	Evaluation criteria
Framework Internal budgeting should play a key role in the financial management framework. The internal budgeting cycle should be linked to the business planning process and be focussed on, and aligned to the organisation's objectives, outputs and strategies.	• the internal budget process is driven by corporate objectives and output delivery targets and is consistent with external accountabilities; • managers' responsibilities are clearly defined and understood; and • internal budgeting is embraced and supported by both senior management and line managers.

Preparedness
Organisations should have prepared for the introduction of the accrual/output framework. In identifying the impact on its internal budget processes, organisations should have considered how to prepare managers and staff (for example, assessing their skills and meeting their financial information needs).
	• the organisation has prepared for the implementation of the accrual based output management environment as evidenced by the following:
	  • internal budgeting processes and practices reflect the requirements of accrual-based output management;
	  • managers and their staff are prepared so they can develop and manage their budgets in the new environment; and
	  • the financial information needs of line and senior managers are assessed and met.

Development and revision processes Procedures for the development and revision of budgets are efficient and not so complex or onerous as to detract from the effective conduct of the organisation's operations and the delivery of its outputs.	• the internal budget development process is efficient in terms of time and cost; and • the organisation has adopted practices to enhance the effectiveness of its internal budgeting development and revision processes.
Monitoring & review processes The budget plays a key role in the organisation's control and decision making processes, including the monitoring and management of performance.	• financial performance is measured regularly and consistently; • the internal budget, and information on actual performance against budgets is used by managers to support decision making; and • there are effective processes to ensure the accuracy of management reports.

Performance information

1.13 Planning for this audit commenced in September 2000 with research into internal budgeting practices and the development of the survey instrument and audit program.

1.14 As well as preparing this report on the overall results of the audit, the ANAO provided to each of the organisations subject to detailed fieldwork, a comprehensive management report, including an assessment of their performance against the evaluation criteria and recommendations for improvement, where necessary. The organisations have responded positively to the findings and recommendations presented to them and where appropriate, advised of remedial action taken or proposed.

1.15 The total cost of the audit was $330 000.

2. Audit Findings

Introduction

2.1 This chapter discusses the audit findings and recommendations under the following four headings.

- Framework;
- Preparedness;
- Development and revision processes; and
- Monitoring and review processes.

2.2 Together these four areas constitute the central elements in an effective internal budget process. The audit results are presented in two categories—audit findings from detailed fieldwork and the survey (where applicable), and examples of sound and better practices identified during the audit.

2.3 The audit findings from the fieldwork are largely process issues that affect the efficiency and effectiveness of the organisation's internal budget. The data metrics and qualitative characteristics taken from the survey results are presented to assist organisations to measure the efficiency and effectiveness of their internal budgeting processes. The sound and better practice observations relate to business practices identified in the organisations audited, which, if adopted, could strengthen internal budget processes of other organisations and lead to improved effectiveness and efficiency.

Framework

Introduction

2.4 The development of the internal budget should be an integral part of corporate and business planning processes and support decisions on the allocation of resources. Without effective integration, there is a risk that the allocation of resources will be inconsistent with, or not support the strategic objectives and direction of the organisation. Effective integration also promotes better understanding amongst managers of how their individual activities and budgets fit into organisation-wide responsibilities.

2.5 A critical feature of the internal budget development process is the collection of information from and accountability to, a wide range of internal and external stakeholder groups. Communication with stakeholders promotes a greater understanding of the organisation's priorities and goals and helps to develop a greater commitment to these goals and to the internal budget. The process also assists to ensure that internal resource allocations are realistic and appropriate and reflect critical imperatives, including available external funding limits.

Summary of audit findings

Table 4

Framework

Principle
Internal budgeting should play a key role in the financial management framework supporting the allocation and management of scarce resources. The internal budget should be linked to the business planning process and be focussed on, and aligned to the organisation's objectives, outputs and strategies.
Evaluation criteria
The internal budget is driven by corporate objectives and output delivery targets and is consistent with external accountabilities. Internal budgeting is embraced and supported by both senior management and line managers. Managers' responsibilities are clearly defined and understood.
Audit findings
Amongst the organisations who responded to the survey: • 84% indicated the internal budget was linked to their corporate planning process; and • most indicated the internal budget was a key part of the operational or business planning process. Of the eight organisations reviewed in detail, the audit found that the preparation of the internal budget was integrated with the organisation's strategic or business-planning framework in seven organisations. The following matters were also identified: • only two organisations had established formal budget committees to oversee the budget development process; and • managers' budget development responsibilities were not clearly defined and widely understood in three organisations.
Sound and better practices
The following sound and better practices were noted during the audit: • discussions and liaison with key external stakeholders formed an important part of strategic and business planning, including budgeting processes; • the development of internal budgets was closely integrated with corporate and business planning processes; • budget preparation and management responsibilities were clearly identified in policy and procedural documentation and in individual performance agreements; and • a senior management committee was established to oversee the development of the internal budget.

Detailed findings and analysis

Integrating internal budgeting with planning

Findings from the survey

2.6 Respondents to the survey were asked to rank the following five roles for the internal budget from most important to least important:

- part of strategic planning process;
- part of operational or business planning process;
- part of internal control structure;
- resource allocation tool; or
- an accounting process.

2.7 The most popular view amongst the survey respondents was that the internal budget was a part of the *operational or business planning process*. Eighty-three per cent of the organisations that responded to the survey either rated this as their first or second preference. The least popular view of internal budgeting, amongst the organisations surveyed, was that it is an *accounting process,* with 79 per cent of organisations nominating this as either their fourth or fifth choice. These results point to a broad appreciation of the role the internal budget can play in the planning and financial management framework.

Findings from detailed fieldwork

2.8 The audit found that the preparation of the internal budget was integrated with the organisation's strategic or business planning processes and included the assessment of external factors in seven of the organisations reviewed. The organisations audited exhibited a variety of different processes to facilitate the alignment of budgeting and planning processes. Among the better practices observed were:

- promulgation by senior management of detailed business planning guidance documentation requiring financial plans (or budgets) to be developed by operational areas as part of their business planning process. These guidelines contained the following information:
    - linkage between corporate objectives/priorities and local strategies and responsibilities;
    - details of key business assumptions;
    - details of resource requirements, both staff and financial;
    - performance indicators;

    - the need for action plans for implementing corporate and local strategies; and
    - description of the organisation's outputs.
- formal processes to facilitate the continuous integration of corporate priorities into the planning and budgeting cycle in order to ensure budget reiterations continue to be relevant to the organisation's priorities; and
- matching total internal budget resource requirements with external funding availability and constraints.

2.9 As might be expected, the primary external considerations related to the level of funding available. The audit found that involved dialogue with external stakeholders was most prevalent in organisations with critical external service imperatives. Among the organisations audited, contact with key external stakeholders was critical to identify, amongst other things:

- current industry and/or commercial expectations and developments;
- funding arrangements, through for example; appropriation, levies and fees/charges;
- key drivers of change in the industry or market; and
- level of demand for, and satisfaction with services.

2.10 The major issues arising under this criterion from the detailed fieldwork are discussed in the following paragraphs.

Integrating responsibility and performance

2.11 Effective financial management requires the clear definition of the broad range of responsibilities encompassing planning and controlling both cash and accrual financial information. In particular, to ensure they are widely and consistently understood, the budget management responsibilities of managers and their staff should be clearly articulated and defined. General or broad statements of budget management responsibility may not be sufficient to avoid uncertainty about expectations and measures of accountability.

2.12 The organisations audited had a variety of formal and informal methods to communicate budget management responsibilities. Among the better practices observed were:

- clear articulation of financial and budgetary responsibilities in performance agreements, in budget guidance documentation and/or in approved corporate and business planning policies;

- establishment of local working groups to manage the budget preparation process; and
- inclusion of responsibilities in business plans or in supporting action plans.

2.13 The Australian National Audit Office (ANAO) considers that including financial management and budget responsibilities in responsible officers' performance agreements is the most effective approach. The inclusion of responsibilities in performance agreements may also promote a better appreciation of the role of the individual's tasks or projects in the achievement of the organisation's objectives and targets.

2.14 Three of the organisations had clearly articulated budget management responsibilities in individual performance agreements and ensured managers were accountable for performance against those responsibilities. In two further organisations, while there was broad recognition in performance agreements, of the need to comply with budgets, performance expectations were often less clear.

Commitment by managers

Senior management

2.15 A critical element in effective budget development is the visible support and involvement of the organisation's senior management. The ANAO's recent benchmarking study of the Chief Financial Officer (CFO) function[6] reported that 85% of the CFOs participating in the study nominated 'budgeting' as an area of primary responsibility.

2.16 This audit found senior management played an important role in the development of the internal budget in seven of the organisations audited. While senior management involvement may occur in a variety of ways, better practice is for the development of the internal budget to be overseen by a budget committee, which is representative of the organisation. The functions of a budget committee may include:

- coordination of budget preparation;
- development of timetables;
- allocation of responsibilities;
- provision of information and guidelines;
- evaluation of budget bids;

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6 ANAO Audit Report No.28 2001–2002, *An Analysis of the Chief Financial Officer Function in Commonwealth Organisations.*

- communication of final approved budgets, including details of changes to bids; and
- continuing assessment of budgeting processes.

2.17 Only two organisations had formally established separate committees, comprising representatives of senior management, to deal with internal budget matters. In both of these cases, these committees represented cross-sections of the entire organisation ensuring the relative views of the areas involved in preparing internal budgets were available and able to be considered. In the other organisations audited, the role of a budget committee was subsumed, to varying degrees, within the responsibilities of existing senior management groups or committees. This latter approach may often be the most practical and cost-effective solution, particularly in the case of smaller organisations.

Line or operational managers

2.18 The views and expertise of operational managers and their staff should be a key part of the effective production of the internal budget and organisations should strive to establish a budget-friendly culture such that line managers have:

- ownership of their part of the overall budget;
- appropriate level of involvement;
- belief and commitment that the budget process is meaningful and adds value to their area of operations; and
- access to clear communication of strategies, targets and changes to budget bids.[7]

2.19 A lack of support from line managers can occur when these elements are not in place and can lead to problems with the budget development process. The perceptions of staff about the role of internal budgeting has a significant influence on the extent to which it can effectively contribute towards the achievement of the organisation's goals and ability to play a positive role in the business planning process. For example, if line managers do not feel that budgets accurately reflect the way they operate or there is a lack of communication about the evaluation of budget bids, they may feel disenfranchised and spend little effort on budget matters, including monitoring.

2.20 ANAO found that line managers in six of the organisations audited exhibited an effective level of commitment and/or ownership to internal budgets. In ANAO's opinion, the strength of this commitment and ownership was enhanced in those situations where budget management performance

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7 Ian Henderson, *Does Budgeting have to be so Troublesome*, Charter, February 1998, pp. 38–41.

responsibilities were clearly articulated. If managers' responsibilities are not clearly defined and understood, this lack of clarity and formality may well pose a risk to the line managers continued commitment and understanding.

2.21 Amongst the organisations audited, the level of commitment to, and ownership of, the internal budget tended to be reduced in situations where:

- the process is largely driven by the corporate areas or has minimal input or commitment from senior management, in particular concerning the strategic direction of the organisation;
- procedures for the development of internal budgets, including approval processes were not clearly defined and consistently applied throughout the organisation;
- line managers are not sure what their final budget allocation is or do not understand how it was derived;
- changes to internal budgets are made centrally and are not always subsequently and clearly advised to managers;
- line managers are held responsible for managing budget items they have no control over; and
- budget and management responsibilities are not clearly defined and communicated throughout the organisation.

Conclusion—framework

2.22 Overall, the audit found that internal budgeting formed an important part of the financial management framework in most of the organisations reviewed. In these organisations, the development of the internal budget was closely linked to business planning and in this way; the organisations were able to ensure the allocation of resources aligned with objectives, strategies and priorities. Furthermore, in most organisations, senior and line managers respectively, were properly involved in the development of internal budgets and demonstrated commitment to successful budget outcomes.

2.23 The main shortcoming identified was the fact that budget management responsibilities were not always clearly defined or articulated, leading in some cases, to instances of inconsistent understandings of these responsibilities.

Recommendation No.1—Managers' responsibilities

2.24 To improve accountability for internal budget outcomes and enhance the effectiveness of financial management, it is ***recommended*** organisations ensure internal budget management responsibilities are clearly articulated and communicated through one or more of:

- approved internal budgeting or business planning policy/procedural documentation;
- business plans or individual work area action plans; and/or
- responsible managers' performance agreements.

Preparedness

Introduction

2.25 In preparing for the introduction of the new accrual-based, output management framework, organisations should have considered the impact on their internal budget processes. In particular, organisations should have carefully considered how to prepare managers and staff, including the assessment and upgrade, where necessary, of their skills and determining how to meet their financial information needs.

2.26 Operating within the new framework has required organisations to deal with the impact of a range of new factors including:

- establishing budgets for the full accrual-based cost of operations;
- identifying and accounting for the full cost of the resources used or acquired;
- identifying and defining outputs and outcomes and linking the cost of operations to these;
- understanding and applying new financial management concepts; and
- introducing new accountability and financial performance measurement requirements.

Beyond Beancounting 2000

2.27 During 2000, CPA Australia released a report[8] on the progress of public sector organisations in the area of financial management since the release in

8 *Beyond Beancounting 2000—A Benchmark of Effective Financial Management in the Australian Public Sector*, CPA Australia, 2000.

1997 of *Beyond Beancounting—Effective Financial Management in the Australian Public Sector, 1998 & Beyond*. The 2000 study found…

> …considerable progress has been made across the public sector in implementing a financial management framework that contains many elements of commercial accounting, budgeting and costing practice.

2.28 Many of the results reported by the study suggest a greater level of importance is now being attached to robust financial management practices, including budget preparation and financial reporting in the APS. However, the study also noted there remains scope for improvement, specifically in relation to the evidence which suggests that:

- many organisations are yet to move away from a cash-based focus as the main source of information for internal decision-making;
- many organisations continue to operate their systems in a dual cash and accrual information format; and
- financial management skills of line managers are perceived to be lower than in 1997.

2.29 Regarding this latter point, the report comments that this reflects the increased complexity of financial management in the accrual-based environment and recognises the steep learning curve faced by line managers. While it is likely there has been an increase in the expectations of senior management following the adoption of accrual-based financial management, this result may also reflect a shortage of management accounting skills in the APS. For example, in July 2001, the ANAO reported[9] that the tight employment market was making it difficult for organisations to acquire and retain accounting and finance staff with the skills needed to effectively operate in an accrual-based environment.

2.30 The Preparedness criteria were not applicable to two of the organisations in the audit as they have operated with accrual-based information and in an output focussed environment for some time. These two organisations are not dependent on appropriation funding nor is the cost of their operations reported in the Portfolio Budget Statements of their respective portfolio Department.

[9] ANAO Audit Report No.1 2001–2002, *Control Structures as part of the Audits of the Financial Statements of Major Commonwealth Entities for the Year Ended 30 June 2001*, p. 30.

Summary of audit findings

Table 5
Preparedness

Principle
Organisations should have prepared for the introduction of the accrual/output framework. In identifying the impact on its internal budget processes, organisations should have considered how to prepare managers and staff (for example, assessing their skills and meeting their financial information needs).
Audit evaluation criteria
The organisation has prepared for the implementation of the accrual-based output management environment as evidenced by: • internal budgeting processes and practices reflect the requirements of accrual-based output management; • managers and their staff are prepared so they can develop and manage their budgets in the new environment; and • the financial information needs of line and senior managers are assessed and met.
Audit findings
Each of the six organisations reviewed had assessed how to prepare and manage their internal budgets in the new environment, however, based on the results of detailed testing it was considered: • three organisations had invested insufficient effort into preparing managers to develop and manage budgets in the new environment; and • three had not fully assessed the financial information needs of their managers under the new framework.
Sound and better practices
The following sound and better practices were noted during the audit: • internal budgets were aligned to the organisation's outputs in the FMIS; • organisation-specific training was provided on the operational impacts of the new accrual-based, output management framework, including information on accrual accounting, resource and performance management and decision-making; and • line managers, supported by sufficient reporting functionality within the FMIS are responsible for defining and meeting their financial information needs.

Detailed findings and analysis

Operating in the new environment

2.31 Reflecting the strength of business planning processes observed during the audit (discussed above), four of the organisations had integrated the management of outputs into local business planning and budgeting cycles or effectively ensured line managers understood how their areas of responsibility contributed to the organisation-wide output framework. A better practice noted during the audit was the requirement for line managers to record in the FMIS how their budget items aligned with the organisation's outputs.

2.32 Managers should be responsible and accountable for the full (accrual) cost of the resources they control, including their contribution to outputs, and not merely the associated cash-expenditure. The results of the audit suggest that many organisations are, for a variety of reasons, yet to fully move away from the management of their internal budgets on a cash basis and in some cases are still separately reporting cash and accrual information. Among the organisations audited there were marked differences in the level of devolved responsibility for the management of the accrual costs of resources and at the time of the audit, only one had fully devolved responsibility for accrual-based costs to operational or line managers.

2.33 The audit noted that the financial management focus of many line managers continues to be on cash-based issues, for example, the level of cash expenditure or receipts, and they had little incentive to understand accrual information.[10] In these cases, much, if not all, the responsibility for managing accrual costs was located within the central finance area.

2.34 This situation increases the risk of inconsistent financial management practices developing between those managers operating to an accrual-based outcome and those operating to a cash-based outcome. Ultimately, this may mean that not all managers are operating on, nor understand the basis by which the organisation is externally accountable. Further, an over-concentration on cash-based information to the detriment of other resources may undermine the achievement of financial management reform in the new accrual-based environment.

2.35 The audit observed instances involving the preparation and use of separate sets of accrual-based and cash-based financial reports. Duplicate reporting adds additional burden (and cost) onto the management reporting process, and in

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[10] The most common differences between accrual and cash accounting relate to the recognition, on an emerging basis, of the cost of asset ownership and usage (depreciation), the cost of employees' entitlements (including recreation and long service leave) and the recognition of revenue and expenses as they are earned or incurred and not at the time of the cash impact.

some cases, as observed during the audit, results in the use of subsidiary or shadow records by line managers. Cash information should be reported as an integral part of accrual management information (for example, in the form of a Statement of Cash Flow) and should not be reported separately.

2.36 The audit also observed the importance of developing sufficient infrastructure to support the introduction of fully devolved accrual-based financial management. Those organisations in the audit that have had to contend with accrual information over a longer time frame advised that the full integration of accrual information occurred over a number of years. In addition it required the development of tools for the accurate calculation and dissemination of accrual information, the identification of gaps and deficiencies in skill levels and, in some cases, the recruitment of appropriately qualified staff.

Preparing managers and their staff

2.37 In July 1999 the ANAO reported that…

> …line management and finance areas are generally not well prepared for the new accrual output/outcomes environment in terms of both their understanding of the new environment and the skills necessary to maximise the management benefits…much had to be done to better focus senior executives and managers on accrual-based financial information and the outputs and outcomes budgetary framework.[11]

2.38 Overall, this audit has found improvement in this area, although the level of improvement was not consistent across all organisations. For example, each of the organisations audited had invested in the preparation of their managers to operate in the new environment by at least offering introductory training designed to raise awareness about the new framework. However, only three organisations followed up this introductory training with more detailed and organisational-specific training, dealing with the application of the new framework and illustrating financial and management accounting skills using accrual information. A better practice observed during the audit was the delivery of organisation-specific training providing practical examples of potential enhancements to financial management and business decision-making practices following the adoption of the new framework.

2.39 The variation in the level of investment in training can be explained, in part, by the fact that organisations made varying assessments of the extent to which line managers would be involved with accrual-based information (as discussed above). However, in those organisations that did <u>not</u> provide organisation-specific training, little improvement in financial management

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[11] ANAO Audit Report No.2 1999–2000, *Use of Financial Information in Management Reports*.

practices was observed. For example, line managers often reported difficulties applying the knowledge learned to the workplace and in other cases, opportunities to apply the knowledge and skills learned during training have not materialised when not reinforced by day-to-day applications. Further, the training offered by some organisations did not adequately address the changes required to managers' behaviour with the move to the new framework.

2.40 At the time of the audit, several organisations had proposed the development of organisation-based training to demonstrate the application of accrual information to improve business management and enhance the understanding of their line managers of the new framework.

Financial information needs

2.41 The identification of the financial information needed by managers should be determined by reference to their financial management responsibilities. As financial management responsibilities have changed with the transition to the new accrual and output-based environment, the financial information needs of managers should be re-assessed and, where necessary, improvements or amendments made.

2.42 Only three of the organisations audited had undertaken a formal assessment of the financial information requirements of their managers as they moved into the new accrual-based environment. Other organisations relied on less formal means to assist line managers identify and discuss issues impacting upon their financial management requirements, such as FMIS User Groups, Finance Managers conferences or meetings and information sessions.

2.43 Only one organisation was able to rely on the functionality of its FMIS to fully address the financial information needs of managers. Amongst the other organisations, line managers often placed reliance on subsidiary applications (for example, spreadsheets) to supplement the financial information available from the FMIS. At the time of the audit four of the organisations examined had commenced, or had planned improvements to the financial reporting functionality associated with their FMIS in order to address the financial information needs and requirements of line managers.

Conclusion—preparedness

2.44 The level and type of preparatory work undertaken for their introduction to the new framework varied considerably amongst the organisations audited. Among the most critical issues identified was the lack of organisation-specific training and the need for formal assessments of the financial information needs of managers. The audit also found that managers in some organisations continue to focus on cash-expenditure issues and observed that cash-expenditure was being separately reported, rather than as an integral part of accrual-based financial information. Given these results, it is considered there is a significant risk in the organisations involved that managers may still not be sufficiently skilled in accrual-based financial management, including financial management decision-making.

Recommendation No. 2—Operating in an accrual-based environment

2.45 To encourage further improvements in financial management practice, which is necessary for the successful implementation of the new accrual-based, output and outcomes management framework, it is ***recommended*** that organisations:

- assess the benefits, in terms of enhanced financial management and accountability, of devolving financial responsibility, to line managers, for the full accrual-cost of the resources they control; and
- reassess the financial information needs of managers based on their financial management responsibilities.

Implementing the recommendation

2.46 Audit Report No.2 1999–2000 contains an analysis of the critical issues organisations might consider when implementing changes to financial management arrangements. It provides a summary of the steps which should be addressed under the following headings:

- financial information assessment and delivery;
- preparing managers and staff; and
- preparing the FMIS.

Development and revision processes

Introduction

2.47 An effective internal budget development process requires careful planning, coordination and an appropriate level of administrative and IT support. Organisations should ensure the level of investment in their budget development process is commensurate with, and appropriate to, their circumstances, including the stability of its business and the extent of devolved financial management responsibility.

Summary of audit findings

Table 6

Development and revision processes

Principle
Procedures for the development and revision of budgets are not so complex or onerous as to detract from the effective conduct of the organisation's operations or the delivery of its services/outputs.
Evaluation criteria
The internal budget development process is efficient in terms of time and cost. The organisation has adopted practices to enhance the effectiveness of its internal budget development and revision processes.
Audit findings
Based on the information supplied by respondents to the survey, ANAO calculated that the mean cost of internal budget development processes was 0.11 per cent (median 0.08 per cent) of total departmental expenses and that the mean time period (hereafter called days-effort) for the development of the internal budget was 281 days (median 115 days). Respondents reported a considerable range in costs and days-effort largely reflecting the different approaches to budget development and views on the role internal budgeting plays in the financial management framework. In relation to the eight organisations reviewed: • only one organisation fully demonstrated the key characteristics used to assess budget preparation processes; • three organisations have formal processes in place to regularly measure the efficiency and/or effectiveness of their internal budget preparation performance; • two organisations use forecasting techniques in the ongoing management of financial performance (two further organisations regularly use forecasting to ensure financial estimates remain appropriate); and • seven organisations had formal and coordinated processes for revising budgets during the year.
Sound and better practices
The following sound and better practices were noted during the audit: • information on the development of the internal budget, including policies, guidelines and templates were readily available through an intranet; • the internal budget is developed using a zero or priority-based budget model which ensures the allocation of resources was based on pre-defined criteria and objective parameters; • the internal budget is developed utilising the FMIS or corporately managed specialised budget management software, interfaced with the FMIS; and • detailed internal budget preparation instructions explaining, amongst other things, key assumptions and imperatives, methodology, timetable and information requirements are provided to budget preparers each year.

Detailed findings and analysis

Data metrics

2.48 A series of data metrics were calculated based on the information provided by survey respondents to highlight the relative investment in the development of internal budgets and to gauge relative efficiencies in terms of time and cost. These metrics provide a useful point of reference enabling organisations to measure and compare the cost and the level of effort involved in the internal budget development process and may be used to highlight opportunities for process improvement.

2.49 The ANAO has provided details of both the mean and median. In this case, the *mean* is the total amount or score for the responses provided divided by the number of responses, whereas the *median* is the middle amount or score in the range of responses. By presenting both the mean and median, the impact of the large range of responses, and particularly, responses which fall outside of normally distributed boundaries (that is 'outriders') is able to be minimised. The key metrics used in this audit are shown in Table 7:

Table 7

Data metrics

No.	Metric
1	The cost of the development of the internal budget as a proportion of the organisation's total departmental expenses (or equivalent).
2	The proportions of effort (as measured by days, costs and the staff involved) in each of the following phases of the development of the internal budget: • setting parameters—establishment of budget guidelines, including identifying funding constraints and who is required to budget for particular costs; • briefing and distribution—ensuring managers receive instructions and/or 'toolkits' to enable them to effectively take part in the budget development process; • preparation—compilation of internal budget bids and estimates; • evaluation and consolidation—evaluation and consolidation of the preliminary budget estimates and any revisions made as a result; and • approval—the consideration and approval of budget proposals.
3	Total time taken in the development of the internal budget. The measure used (days-effort) is an estimate of the **actual time** consumed by the process and not a measure of the number of calender days that have passed. It is therefore a product of the number of staff involved in the process and the extent of their involvement.

Metric 1—Proportionate cost of developing the budget

2.50 The mean cost of developing the internal budget amongst the survey respondents was 0.11 per cent (median 0.08 per cent) of departmental expenditure (or equivalent).[12]

2.51 Amongst the survey respondents, there was a large range in the reported proportionate costs—from 0.01 per cent (in several cases) up to 0.35 per cent. There are several likely reasons for this. Most significantly, it reflects the fact that the organisations utilise different approaches (including methodologies and tools) and operate with varying degrees of devolution of responsibility for the development of internal budgets.

2.52 During detailed testing, ANAO identified the higher proportional cost organisations tended to have put in place more sophisticated budget development processes, generally involving a greater number of line or operational managers. These organisations also tended to view the development of the internal budget as an important part of the financial management framework and therefore were willing to put greater investment in it. On the other hand, the lower proportional cost organisations tended to have greater levels of centralised control.

2.53 A further key factor explaining the range of reported costs is the close integration, in many organisations, of budgeting and business planning processes. Based on the outcome of detailed testing, it is considered very likely that the costs reported by many organisations, particularly amongst the higher cost organisations, may have encompassed both business planning and internal budgeting processes because the two processes are so closely integrated that the costs cannot be readily distinguished.

2.54 As might be expected given economies-of-scale which are available to them, larger organisations had the lowest mean proportionate cost of 0.08 per cent (median 0.05 per cent). Small organisations had the largest mean proportionate cost at 0.15 per cent (median 0.10 per cent).

Metric 2—Proportion of effort involved in developing the budget

2.55 As shown in Figure 1, overall, amongst the organisations surveyed, the preparation and evaluation phases (as defined above) accounted for the highest proportion of the effort (as measured by days-effort, cost and the staff involved) in the budget development process.

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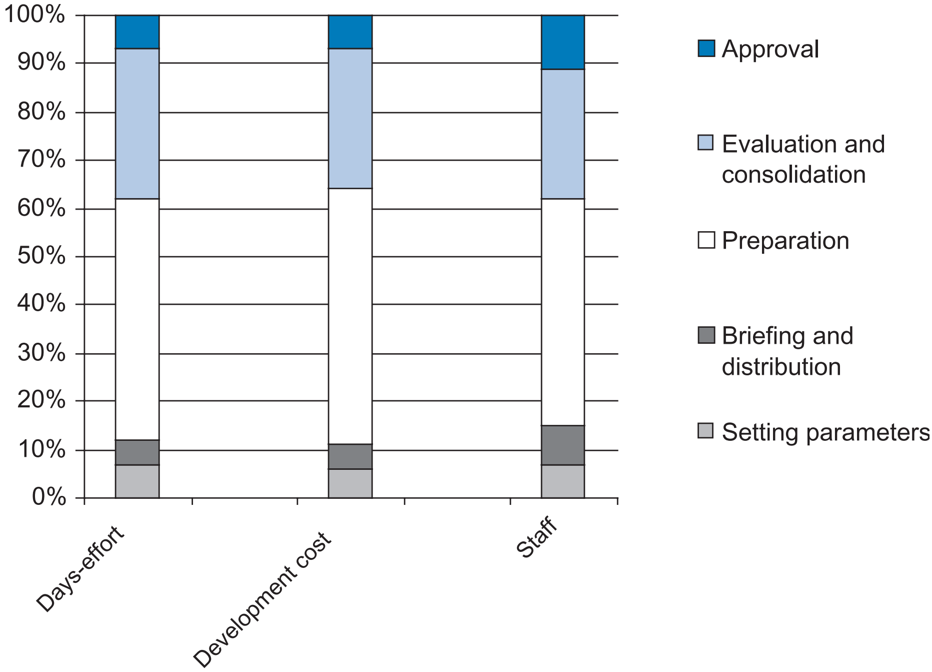
12 These results are not directly comparable to those in ANAO Audit Report No.25 2000–2001, *Benchmarking the Finance Function* which reported that the median cost of the budgeting and analysis function, including the budget development process, in APS organisations was 0.158 per cent of total organisational expenditure.

Figure 1
Breakdown of total days-effort, development cost and staff involved in budget development



Source: ANAO

2.56 Overall, the organisations surveyed invested approximately 50 per cent (on average) of their total budget development effort in the preparation phase and approximately 30 per cent into the evaluation phase. Far less significant, on average, were the remaining stages dealing with preliminary planning, organising and approval.

2.57 Nearly all the organisations surveyed reported that, either the preparation or evaluation phases were the most time consuming; involved the most staff; and were the most costly phases of the budget development process. Only five organisations reported that either the setting parameters phase or the approval phase took the longest, was the most costly or required the highest proportion of staff. In each of these organisations, the budget preparation process was either largely centralised or involved only a relatively small number of staff.

2.58 The better performing organisations from the detailed fieldwork tended to put more effort into the preparation phase and marginally less effort into the evaluation phase than the average of the survey respondents. They also put less effort into the planning phases, largely reflecting the fact that these organisations have mature and well-defined processes, reducing the need for a significant effort each year in these preliminary stages.

2.59 However, this was not always true and each organisation should carefully consider its own circumstances and the environment in which it operates when determining an appropriate internal budget development strategy. For example, one organisation advised that, because the nature and level of its business was relatively stable, it was more efficient to invest a greater proportion of time and effort in the preliminary phases. Comparatively less effort was required in the evaluation of bids. Another organisation invested the majority of its budget development effort into the evaluation phase and less effort (proportionately) into the preparation phase. The organisation advised that the highly consultative approach it has adopted to the evaluation of budget bids has provided high levels of understanding of, and commitment to, internal budget outcomes.

Metric 3—Time taken to develop the internal budget

2.60 The survey respondents reported a considerable range in the time taken (days-effort) in the budget development process. This largely reflects the different approaches taken to development of the budget, including the impact of the integration of business planning and the extent of devolution of responsibility for budget development. The size of the organisation did not necessarily have a significant effect on the reported days-effort. The mean days-effort for the development of the internal budget was 281 days, while the median was 115 days.[13]

2.61 The significant difference between the mean and median in this case is primarily due to the large days-effort reported by three large organisations. Each of these organisations operated with heavily devolved budget development responsibilities, involving significant numbers of staff. This is not to say that the days-effort reported by these organisations were inappropriate. On the contrary, detailed testing has suggested the significant investment afforded by these organisations, has generally resulted in a better internal budget outcome, including higher levels of control, understanding and commitment.

Measuring efficiency

2.62 While these metrics are a useful source of relative time, cost and effort measures, they do not, on their own, provide an accurate measure of the efficiency of internal budget processes. This is because attitudes towards and approaches used to prepare budgets varied considerably. The detailed fieldwork phase also considered other relevant factors, including the size and nature of the organisation, the extent of the devolution of responsibility for budget preparation, the level of commitment towards and ownership of budgets and the accuracy of the budget outcome, to more accurately assess the efficiency of the internal budget development process.

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[13] These results cannot be directly compared to 'elapsed time' measures contained in ANAO Audit Report No.25 2000–2001, *Benchmarking the Finance Function* as these are based on 'calendar days'.

2.63 Overall, the audit found the most efficient budget development processes were characterised by high degrees of coordination, consistency of practices (particularly in situations of devolved budget development responsibility) and clarity in the communication of information to budget preparers. Another common feature of the more efficient processes observed during the audit was a high level of involvement in the development process by senior management.

Conclusion—metrics

2.64 Overall, those organisations which have invested more time and effort into the budget development process and which have integrated the development of the internal budget with business planning, have generally achieved better internal budget outcomes and greater levels of understanding and commitment to the budget.

2.65 The considerable range in the data metrics highlights the importance of organisations carefully managing the level of investment put into the development of the internal budget. In this regard, the level of investment should be determined in light of each organisation's circumstances and, in particular, should not unnecessarily tie up resources required for the effective delivery of services.

Qualitative characteristics

2.66 ANAO used six better practice characteristics to assess the effectiveness of budget preparation processes. Table 8 shows, for each characteristic, the number of organisations which demonstrate the better practice.

Table 8
Qualitative characteristics

Better practice characteristic	Fully demonstrated	Partially demonstrated	Not demonstrated
1. A dedicated team which is responsible for the internal budget. Common responsibilities are to: • co-ordinate and monitor the preparation process; • communicate clear objectives and strategies; and • provide support, advice and guidance.	7	1	0
2. An internal budgeting policy is approved and widely disseminated to provide appropriate authority to managers and their staff.	4	1	3
3. Annual parameters or guidelines are developed to provide budget preparers with a sufficient level of detail to facilitate the development of quality bids that reflect the organisation's objectives, strategies and imperatives.	5	3	0
4. Budget or cost centres are responsible for preparing their own budgets.	6	2	0
5. The budget preparation methodology exhibits characteristics of zero-based or activity-based budgeting theory.	7	0	1
6. Specialised budget preparation software, which is part of, or integrated with, the organisation's FMIS.	2	5	1

1. Dedicated budget team

2.67 A dedicated internal budget team is important to provide the coordination and communication required for an efficient and effective process. It also provides a central point of reference and source of intelligence for budget preparers and managers.

2.68 Of the organisations that responded to the survey, 69 per cent indicated they have a dedicated internal budget team, and many of those that answered 'no', indicated that this function was subsumed into the role of the central finance section (or equivalent). Small agencies were less likely to have a dedicated budget team, tending to rely on their finance manager to assume responsibility for undertaking or coordinating the internal budget process. Larger organisations, particularly those operating in different geographic locations, were more likely to have a dedicated internal budget team.

2.69 The results of detailed fieldwork confirmed the appropriateness of having a dedicated team in the internal budget development cycle. Although there were some variations given their size, each of the organisations had identified resources to fulfil this role. The results of detailed fieldwork confirmed that a dedicated internal budget team was more likely to exist in larger organisations that operate with devolved budget management responsibilities. In these situations, dedicated teams are used to fulfil the need for greater coordination and oversight. Smaller organisations were less likely to have dedicated internal budget resources, they tended to rely on the finance manager or equivalent position.

2. Formal policy

2.70 Senior management should promulgate a policy formally setting out the purpose and role of internal budgeting and clarifying the financial management framework, within which it is undertaken. A policy statement is a useful vehicle for communicating senior management's commitment and can also be used to confirm responsibilities in the process.

2.71 Fifty-four per cent of respondents to the survey indicated they have a formal policy on internal budgeting. Smaller organisations and those with centralised operations were less likely to have a policy document. Those organisations, which did not have a formal policy, use a variety of techniques to communicate budgeting requirements, sometimes informal, including briefings, seminars and e-mail exchanges.

2.72 Detailed fieldwork confirmed the relatively low usage of policy statements concerning internal budgeting. Only four of the organisations audited had formally promulgated statements detailing internal budget policies. One of the remaining organisations was small and tended to rely on less formal methods of communication.

3. Annual guidelines or parameters

2.73 The promulgation of annual guidelines is important to ensure all budget preparers and managers are working to the same priorities, assumptions and constraints. Annual guidelines should also be used as an opportunity to re-clarify or confirm key messages, including timetable issues. A schedule of the information the ANAO considers is appropriate to include in internal budgeting guidelines or parameters is contained in Appendix 1 to this report.

2.74 Ninety-two per cent of the respondents to the survey indicated they develop annual parameters for use by their managers in the budget development process. Although the vast majority of organisations indicated they developed annual parameters, none of them had addressed all of the information requirements included in the survey. The information least commonly provided in internal budget guidelines by survey respondents included:

- statement of the purpose of budgeting;
- the objectives of internal budgeting;
- information on the inter-dependencies between budget centres; and
- information on data capture processes.

2.75 The low response rate to the inclusion of a statement of purpose and information on the objectives of internal budgeting is a particular issue. As indicated above, only 54 per cent of organisations had issued formal internal budget policy announcements, where these matters might otherwise have been expected to be addressed.

2.76 Detailed testing confirmed the high rate of use of annual parameters or guidelines among the organisations audited. However, as was the case with the survey results, inconsistencies in the level of information provided were noted. For example, although five of the organisations promulgate guidelines or parameters each year to assist budget preparers, only two of these included the majority of items listed at Appendix 1.

2.77 One of the organisations reviewed had developed only brief guidelines but at the time of the audit was developing more informative material for its budget preparers. The remaining two organisations, which were both in the small category, did not use formal guidelines and relied on less formal methods of instruction to ensure budget preparers had access to the appropriate level of information and understanding.

4. Alignment of budget responsibilities

2.78 Assigning responsibility for the development of internal budgets to those managers who are responsible for, or who control the services being delivered (and the resources involved), facilitates improved understanding of the cost of those resources and promotes increased ownership of budgets. Eighty-three per cent of respondents to the survey indicated budget or cost centres were responsible for preparing the budget they were expected to manage. Each of the organisations audited had, or was in the process of, devolving responsibility for preparation of internal budgets to line or operational areas.

5. Budget preparation methodology

2.79 The methodology used by an organisation impacts on the efficiency and effectiveness of the internal budget preparation process. Nineteen per cent of the organisations surveyed indicated they only used a traditional approach to budget development. Under a traditional approach, the previous years' budget or actual result provides a baseline for the current year, which is then adjusted for known or estimated changes expected to impact on budget estimates.

2.80 Most of the organisations surveyed indicated they use a traditional approach in conjunction with a better practice methodology, including zero or priority-based budgeting or activity-based budgeting. The term 'zero-based' stems from the concept of starting from a zero point each year. Under this approach, budget bids and requests are framed against a series of criteria, which amongst other things might include the organisation's objectives, priorities and operating assumptions. The burden of proof is shifted onto budget preparers to justify why their budget requests should be met.

2.81 Detailed fieldwork highlighted the considerable variety of methodologies adopted by organisations. Three of the organisations audited used a zero or priority-based methodology to prepare the internal budget. A further four used a more traditional-based budget preparation methodology supplemented by elements of better practice. For example, one organisation factored in adjustments to account for, amongst other things, service delivery levels and productivity initiatives. Only one organisation was mostly reliant on a traditional approach.

2.82 The audit has suggested that a priority-based approach is likely to be more costly, in terms of time and effort, than other approaches seen. However, the additional benefits, including greater alignment between resource allocations and the organisation's priorities or strategies, a greater understanding of budgets and increased levels of transparency, ensure efficiency and effectiveness are not reduced. The audit also highlighted that, in practice, a single budget preparation methodology may not be appropriate and organisations, particularly larger ones, may use a combination of methodologies.

6. Preparation tools

2.83 The tools used to support the production of the internal budget are an important contributor to an efficient and effective process. Many of the respondents to the survey indicated they use a combination of tools but none used manual processes only. Eighty-one per cent of the respondents indicated they use spreadsheets, either on their own or in conjunction with another tool. However, only 25 per cent of respondents indicated they use specialist budget management software. Of the organisations with specialised budget management software, 50 per cent indicated this software was part of, or fully integrated with, the FMIS.

2.84 Detailed fieldwork confirmed the extensive use of spreadsheet-based applications. Six of the organisations audited used a spreadsheet-based application to prepare internal budgets, however, only two of these had integrated these applications with the FMIS or had the ability to up-load this information into the FMIS automatically. Only two organisations utilised specialised budget management software in the development of internal budgets. In both cases, this software was integrated with the organisation's FMIS.

2.85 While spreadsheet applications can be a powerful and valuable tool in the right circumstances, there is often a mistaken perception that they have a low maintenance requirement. Moreover, a number of common problems may be encountered with the use of spreadsheets, or with any software, which has not been properly designed to support an iterative, and inclusive budget preparation process. These problems, which can impair the effectiveness of the application and increase the risk of inadvertent errors occurring, include the following factors:

- lack of centralised control;
- data integrity and security issues;
- lack of integration with other systems;
- inflexible data management and reporting; and
- difficulty maintaining accuracy of formulas and other customised settings.[14]

2.86 While every organisation should assess available solutions in light of their own circumstances and requirements, there are some common functionality requirements desirable in budget management systems. These include the following:

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[14] *Budget Management Software—Ten Rules for Success*, Guy Haddleton, The Chartered Institute of Management Accountants, March 1999.

- *flexibility*: ability to support changes to hierarchy or structure and to handle scenario analysis or modelling by users, including both ad-hoc analysis and formal forecasting;
- *integration/automation*: ability to transfer or import data from supporting systems (if used) and consolidate and map this data to avoid the cost and risks inherent in 're-keying' data;
- *control/reporting*: ability to monitor users, including the management of the submission of bids, changes and revisions and to provide an audit trail and version control so that changes and revisions can be tracked clearly and effectively;
- *user-friendliness*: ability to accommodate and support different user categories; and
- *organisational-wide support*: ability to accommodate shared and simultaneous access (multi-user) to avoid duplication of effort while maintaining security and data integrity.

Conclusion—qualitative characteristics

2.87 The better practice characteristics used to assess the effectiveness of budget preparation processes were partially, or fully demonstrated, by most of the organisations audited. The main shortcomings identified related to the low rate of existence of internal budget policy pronouncements and the low rate of use of specialised budget management software, which is properly integrated with the FMIS.

Measuring budget development performance

2.88 The activities of each organisation should be subject to an ongoing process of monitoring and review to continually or periodically assess their effectiveness and efficiency. The scope and frequency of the formal evaluation and review of activities should depend on an assessment of risk. Monitoring the effectiveness of the development of the internal budget can include the following processes:

- surveying budget managers or clients;
- benchmarking budget development performance;
- programming internal audit reviews or evaluations; and
- self-assessment using, for example, the better practice characteristics mentioned above.

2.89 Five of the audited organisations had established formal or informal processes for measuring their budget preparation performance, or were in the process of doing so at the time of the audit. The processes used to measure performance ranged from regular contact and feedback between the central budget team and line managers, to periodic surveys of budget participants, through to the establishment of a formal benchmarking program to measure processes associated with the development of the budget against similar organisations. Only one organisation had recently requested its internal audit function to undertake an independent review of its budget development process.

Budget reviews and revisions

2.90 Approved budgets should be periodically reviewed and revised to ensure the estimates remain appropriate, particularly in light of changing business environments, circumstances or operational performance. Eighty-five per cent of the respondents to the survey indicated they have formal processes in place to re-assess approved budgets during the year. Seventy-five per cent of those organisations that formally reviewed their budgets do so either six monthly or quarterly, while a small number formally review their internal budgets each month. The remaining organisations indicated they hold a formal review when circumstances indicate the approved budget is no longer appropriate or requires review.

2.91 Most of the organisations that responded to the survey indicated they have arrangements in place to identify, approve and process variations to the approved budgets at any point during the year. However, a small number of organisations reported that revisions to approved budgets are only processed following the formal review processes.

2.92 A number of organisations indicated that line managers are being encouraged to live with variances and to manage the bottom line. In these cases, organisations reported a significant reduction in the number of revisions processed, particularly outside of formal review processes. However, the large number of variations reported by several organisations, indicates this view is not widespread and there appears to be a propensity to make changes with little attempt to manage within the available budget. All of the respondents to the survey had, either a formal process to review approved budgets, or arrangements for the processing of budget revisions.

2.93 Budget revisions were generally well coordinated and controlled in the organisations audited. However, a major shortcoming identified related to instances where budget revision processes were too informal and not sufficiently documented, including the justification for revisions and a lack of any affirmative feedback to budget managers.

Recommendation No. 3—Measuring budget development performance

2.94 To assist with the identification and diagnosis of process weaknesses, and to secure potential time and cost savings through the adoption of improved practices, it is ***recommended*** that organisations periodically measure the efficiency and effectiveness of their internal budget development processes against appropriate external references or benchmarks.

Implementing the recommendation

2.95 The data metrics presented at paragraphs 2.48 to 2.63 and the better practice characteristics discussed at paragraphs 2.66 to 2.86 may be utilised to assist in the measurement of internal budget development performance. These measures provide a useful point of reference and can assist in the identification of potential areas for improvement. Organisations should apply the information contained in this part of the report in light of their own circumstances, including their size and the nature of their operating environment.

2.96 The ANAO will shortly be publishing the results of the second phase of its *Benchmarking the Finance Function* study, which will contain a series of benchmarks, based on responses from participating Commonwealth organisations and from an international group, which may also be useful in the identification of budget development process issues.

Monitoring and review processes

Introduction

2.97 The communication of timely, relevant and reliable financial information is a fundamental component of good corporate governance and is critical to effective performance management.[15] More specifically, monitoring timely and accurate financial information is an important part of effective budget management. Reviewing actual performance against approved internal budgets is a management control that can complement and in some cases substitute more detailed and costly internal accounting controls.

2.98 In its simplest form, monitoring and controlling budgets involves:

- comparing actual performance with approved budget estimates;
- identifying material and/or significant variances between actual results and approved estimates; and
- deciding on what action, if any, to take in relation to these variances.

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15 Audit Report No.2 1999–2000, op. cit.

2.99 Broadly, variances may arise from three scenarios:

- inadvertently: for example, through errors in processing or recording transactions;
- consequentially: for example, through the impact of an error in compiling the budget or in the underlying assumptions contained in the budget; and/or
- operationally: through changes in the level of business or activity, increases in prices for goods/services or from the impact of external influences.

2.100 Regular financial and management reporting has become the norm in APS organisations. The Beancounting 2000 survey reported that all of the organisations surveyed indicated they produce management reports on a monthly basis. Of these, 48 per cent are produced in five days or less and a similar proportion is produced between six and 15 days.

Summary of audit findings

Table 9

Monitoring and review

Principle
The internal budget plays an important role in the organisation's control and decision-making processes, including the monitoring and management of financial performance.
Evaluation criteria
Financial performance is measured regularly and consistently. The internal budget and information on actual performance against budgets is used by managers to support decision-making. There are effective processes to ensure the accuracy of management reports.
Audit findings
In relation to the eight organisations reviewed in detail, the audit found that financial performance was regularly monitored in all organisations. However, only: • three organisations relied on their FMIS for the production of financial reports to line managers; • three organisations had formal processes to ensure the results of senior management's analysis of performance was referred back to line areas; • three organisations included information on key performance indicators or financial ratios in reports to management; and • two organisations used forecasting techniques as a key tool in monitoring performance.
Sound and better practices
The following sound and better practices were noted: • comprehensive financial reports, providing details of actual performance against forecasts and budgets are available from the FMIS to line managers within three days of the close of each period; • the results of the analysis of financial performance by line managers are summarised and incorporated into the management reports provided to senior management; • senior managers are provided with reports incorporating financial and non-financial ratios and performance indicators; • line managers were able to access real-time financial information, through ad-hoc inquiries, from the FMIS; and • line managers are required to certify as to the accuracy and completeness of their monthly financial accounts and provide explanations for any variances from forecasts above minimum thresholds.

Detailed findings and analysis

Monitoring financial performance

2.101 Managers in each of the organisations audited regularly (at least monthly) obtained or were provided with information in order to monitor their financial performance. Amongst the organisations audited, the following issues were noted concerning the monitoring of financial performance.

Accuracy of management reports

2.102 In order to effectively contribute to the management of financial performance, management reports must be accurate. The better practices observed during the audit to ensure the accuracy, consistency and reliability of information in management reports included:

- comprehensive and formal period-end cut-off and reporting processes including reconciliation and certification requirements were formally communicated to key areas;
- using the same chart of accounts for the preparation of the budget (and forecasts) and the recording of actual transactions;
- generating management reports directly from the FMIS;
- controls in place over the addition of new account codes;
- linking account codes to key performance indicators;
- automatic and seamless FMIS cut off procedures; and
- discussion of monthly results to identify any errors and anomalies.

Timeliness of information

2.103 A common benchmark for the production and dissemination of period-end financial reports is between five and seven days.[16] In the organisations audited, financial reports were made available to line managers up to 10 days after period end, with the best time frame of three days. Examples of the causes of delays in reporting to line managers identified in the organisations audited included:

- reports being prepared using spreadsheets populated with information downloaded (manually in one case) from the organisation's FMIS;
- time spent by managers comparing information provided from the FMIS to data held on local applications (usually spreadsheets) and the follow-up of incorrect information; and

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16 Andersen Global Best Practices ® KnowledgeBase, available at <www.knowledgespace.com/gbp>.

- reports prepared centrally from the FMIS not being received in sufficient time to suit local management reporting arrangements, necessitating largely duplicated procedures.

2.104 The better results were found in those organisations which have successfully incorporated (or integrated) comprehensive and flexible reporting functionality within the FMIS. Only three of the organisations audited relied exclusively on their FMIS or utilised specialised reporting software packages, which were interfaced with the FMIS, for the production of financial reports for line managers.

2.105 In most of the organisations reviewed, reports for line managers were prepared within the central financial area or by devolved finance or administrative sections. Two organisations had devolved responsibility to line managers to implement local reporting and budget monitoring arrangements. In these cases, line managers were supported by sophisticated reporting tools (in the FMIS) including a suite of pre-formatted reports and on-line inquiry facilities enabling them to drill-down through various levels of financial details, ultimately to the original source transaction. At the time of the audit, two organisations were implementing more robust reporting functionality within their FMIS in order to provide line managers with more effective access to financial information.

2.106 In most organisations, the preparation of management reports to Boards and senior management took longer (up to 3 or 4 weeks) principally because more customised and informative reports were prepared, including, in some cases, commentary and analysis provided by line managers (see paragraph 2.111). The better practice management reports identified contained the following information:

- commentary and analysis on results to date including explanation of variances;
- commentary on future opportunities and risks;
- key performance indicators, including both financial and non-financial measures;
- financial ratios; and
- the following financial statements containing budget, actual and forecast figures:
  - Statement of Financial Performance (Operating Statement);
  - Statement of Financial Position (Balance Sheet);
  - Cash Flow statement; and
  - Capital expenditure.

2.107 Only three organisations included information on financial ratios and/ or key performance indicators in reports to senior management. By supplementing financial information with the results (and analysis) of key financial and performance ratios or indicators, managers' attention can be better focussed on trends in key result areas enhancing their ability to make informed assessments and decisions.[17]

Discussion of results and feedback

2.108 Financial information requires analysis and assessment in order to add value to performance monitoring processes. Around period-end, organisations should implement procedures requiring managers to consider performance issues, to analyse variances and to plan for future impacts or 'exceptional' transactions and events.

2.109 While the central finance area or line managers in each of the organisations audited regularly undertook an analysis and assessment of financial information, in most organisations, this analysis of variances was informal and done on a case by case basis, rather than on the basis of pre-established, risk-based or quantifiable factors.

2.110 The effectiveness of management reporting was enhanced in three organisations which had put-in-place processes to ensure financial performance, including the assessment of changes in forecasts, was formally discussed between line managers and the central finance area. In two further organisations, although monthly discussions on performance took place between line managers and the central finance area, there was no documentation of the outcomes of these reviews, nor of any clear explanation for any variances. An obvious exposure from a lack of documentation is that, while monitoring may be occurring, line managers are not effectively being held accountable for their financial management performance by senior managers.

2.111 Another better practice observed during the audit, was for reports to senior management to incorporate commentary and explanations on the analysis of performance by line managers. These commentaries, which included, for example, discussions on external impacts on financial results, status of targets/ projects, achievements against budget and explanations for variances, assisted senior management to be more fully informed and able to focus on strategic responses to the management reports, rather than being concerned about why variances exist in the first place.

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[17] Examples of common financial ratios and performance indicators can be found in *Building a Better Financial Management Framework—Defining, presenting and using financial information* and *Building Better Financial Management Support—Functions, systems and activities for producing financial information*, Australian National Audit Office, November 1999.

2.112 Concomitantly, the value of management information can be further enhanced if the results of the assessment of performance by senior management are communicated to line managers in a manner that enables them to take corrective action. While most organisations had informal processes in place to provide feedback to line managers, only two organisations had formal processes to ensure feedback on the deliberations of senior management was provided to line managers, who were required, as appropriate, to deal with the issues raised. A better practice noted during the audit was for a formal minute to be distributed to key managers providing details of those items which senior management require actioning and of those items (previously raised), which have been resolved.

Reliance on local applications

2.113 As mentioned above, only three of the organisations audited had sufficient reporting functionality in their FMIS to address the financial reporting needs of line managers. Amongst the other five organisations, line managers utilised, to varying degrees, local subsidiary records (generally spreadsheets) to produce financial reports. In some cases, local records were used to re-format or re-present information available from the FMIS. However, and more significantly, in two organisations, local records were used due to an inability to access reliable information from the FMIS. In a further two organisations, line managers advised ANAO that because they were unable to access a sufficient level of information from the FMIS to assist in decision-making or monitoring of financial performance, they therefore maintained additional and separate records.

2.114 If financial reports are not produced from the FMIS or other corporately managed reporting software, which is interfaced with the FMIS, there is an increased risk of inaccurate or inconsistent information being used. This may occur either through inadvertent error or use of non-corporate information, that is, financial information that has not been validated by the central finance management area. Furthermore, the use of local records to supplement (or substitute) corporate reporting systems is inefficient, affecting the timeliness of reporting and resulting in considerable duplication in effort (and information). The time spent maintaining the accuracy of subsidiary records may also distract line managers and their staff from more strategic decision-making and local applications are unlikely, without considerable investment, to be able to support sophisticated analysis in a cost and time effective manner.

Forecasting

2.115 Periodic or regular forecasting of expected budget outcomes can be a valuable tool to test the validity of budget estimates and in this way can also be used to complement or substitute fixed-time budget review processes. Better practice is to extend the use of forecasting techniques to incorporate it into the monitoring of actual performance.

2.116 Five of the organisations audited had monthly forecasting processes in place. However, only two of these, both of which operate in commercial environments, use forecasting to not only continually reassess budget estimates, but also as the main tool for the ongoing management of the allocation of resources and the monitoring of performance.

2.117 In the other organisations audited, forecasting techniques were less formal. They were used predominantly as a means of monitoring the likelihood of achieving approved budget performance or identifying potential variances. In one case, forecasting was used as a means of identifying any potential funding difficulties.

Assist decision-making

2.118 Access to, and understanding of, accrual-based information on financial performance, should be a key source of support for decision-making in the management of resources and the cost-effective delivery of outputs (and achievement of outcomes).[18]

2.119 Reflecting the close ties to business planning (discussed above), internal budget information was found to be an important contributor to decision-making in seven of the organisations audited. In one organisation, at the time of the audit, budget performance information appeared to be of only limited use in the support of decision-making. This limited use is consistent with the fact that the internal budget was not an integral part of the strategic planning and management process.

2.120 Amongst the organisations audited, ANAO was advised that the internal budget, and information on actual performance was utilised to support decision-making in the following areas:

- generate and support future project proposals;
- enable the identification and evaluation of areas for potential growth, and avenues which can be pursued to achieve that growth;
- enable budget managers to monitor and control their operations and meet their financial and operational targets, including management of expenditure against available appropriation funding;
- enable managers to explain performance when questioned (for example, in manager meetings);

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18 Audit Report No. 2 1999–2000, op. cit.

- performance evaluation;
- control resource allocations;
- identify opportunities to cover projected revenue shortfalls or cost overruns; and
- identify issues that may cause the organisation to not meet its goals and strategies.

Conclusion—monitoring financial performance

2.121 In most cases, the internal budget effectively contributed to the organisations' control environment because budget information played an important part of the arrangements for monitoring financial performance. Overall, scope for improvement was identified in relation to the need for more robust reporting functionality in FMISs and in ensuring consistency between line and senior managements' review and analysis of performance.

Recommendation No. 4—Financial reporting

2.122 To identify opportunities for greater efficiency and effectiveness in the management of financial performance, it is ***recommended*** that organisations reassess whether their FMIS continues to be capable of providing financial information in a manner and format sufficient to satisfy the needs of their managers in the new accrual-based, output and outcomes management framework.

Implementing the recommendation

2.123 The internal reporting capabilities of an organisation's FMIS may need to be supplemented by implementing an Executive Information System or third party application, such as report-writer software. These proprietary tools can assist and support more cost-effective and sophisticated analysis of financial information, thereby reducing reliance on non-corporate applications and subsidiary records.

Recommendation No. 5—Financial performance analysis

2.124 Since comprehensive analysis and review are fundamental to the effective management of performance, and through improved communication, greater levels of understanding and more consistent financial performance outcomes are achieved, it is ***recommended*** that organisations ensure:

- financial management reports provided to their senior management include the details of, or a commentary on, the results of any analysis and review of financial performance undertaken by operational or line managers; and
- any matters of significance arising from senior managements' assessment of financial performance, including details of decisions, should be referred to operational or line managers for advice or action in a timely manner.

Canberra ACT
24 May 2002

P. J. Barrett
Auditor-General

Appendices

Appendix 1

Suggested content of internal budget guidelines

As discussed at paragraph 2.73, guidelines should be promulgated to provide budget managers and preparers with a sufficient level of details to facilitate the development of their bids and ensure they are all working to the same priorities, assumptions and constraints. These guidelines may contain the following information/details:

- Organisation's objectives and strategies
- Statement of the purpose and the objectives of internal budgeting
- Explanation of how the internal budget fits into planning cycle
- Internal budget methodology or recommended/preferred approach
- Key business principles, assumptions, priorities and new initiatives
- Details of staffing strategies
- Sources of funds, including external funding limits or constraints and projections of user-sourced revenue and savings/recoveries
- Distinction between capital versus operational budgets
- Details of centrally managed costs and assigned or attributed costs
- Commentary on how to budget and manage specific expenditure items
- Interdependencies between budget centres
- Data capture processes and sources of information
- Key contacts and accountability lines
- Accessing and using budget and planning templates or worksheets
- Timetable
- Explanation of key terms or concepts.

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