Principles for Designing the Finance Organization: A Guide for Reform Efforts and Leadership Transitions

by James L. Chan and Rowan Miranda

Since the turn of the century, many state and local governments have reformed their organizational structures by centralizing authority and clearly defining lines of responsibility. Over time, additional modifications were made through reorganizations by newly elected officials, changes in statutes, and external forces. Today, the finance organization for many state and local governments is more the result of incremental piecemeal changes than thoughtful and rational design. Especially in larger governments, finance organizations are associated with terms such as red-tape, bureaucracy, overlap, and duplication. Incremental efforts at reorganizing the finance function have at best produced marginal benefits. If genuine reengineering of the finance function occurs through the combination of technology modernization and organizational restructuring, it is useful to establish some fundamental principles to guide reform efforts.

In this article, the authors propose a small number of finance organization design principles and illustrate their application by examining the recent charter reform effort in the City of Los Angeles. The term "finance organization" is used to encompass all of the financial management units in the government. Leadership transition teams and charter reform efforts in other jurisdictions can use these principles to guide their restructuring efforts; those that have made recent changes can use the principles to evaluate past actions.

Design Principles

In the authors' view, institutional designers should consider the following seven principles. An effective finance organization:

- has a scope that is *comprehensive* enough to carry out major finance activities,
- establishes *independence* for key finance activities,
- helps the government and its managers discharge *accountability*,
- contributes expertise to *influence policy* formulation and implementation,
- improves the *performance* of service delivery,
- *minimizes overhead costs* of itself and the government as a whole, and
- makes *continuous improvements.*

Comprehensive Scope Principle. An effective finance organization should have authority and responsibility sufficiently comprehensive in scope to encompass the core and related finance functions. The core functions are financial planning and budgeting, implementation (including budget execution, accounting, and reporting), and financial performance evaluation (including auditing). The related functions include purchasing, risk management, and evaluation of compliance with finance-related laws and regulations. Unless the finance organization as a whole encompasses these functions, it runs the risk of frequent "turf wars" that lead to conflict and inefficiency.

Independence Principle. The government should ensure independence for certain key finance activities such as auditing and financial reporting. Such independence is essential to promoting the confidence of the public and the financial community. These resource providers view checks and balances in government as ways to prevent fraud and waste.

Accountability Principle. A successful finance organization strengthens accountability. There are three mutually reinforcing lines of accountability in state and local government. Department heads are accountable to higher-level executive officers. The executive branch is accountable to the legislative body. And the government as a whole is accountable to voters and taxpayers. Since financial accountability is an integral aspect of performance, the finance organization is instrumental in both demonstrating and enforcing accountability. Timely release of the budget document and the annual audit are two well-established means of demonstrating accountability.

Policy Influence Principle. An effective finance organization does more than implement controls. When resources are scarce, financial considerations often make or break policy or program proposals. The finance organization should possess the expertise to provide objective information and advice in policy formulation and implementation. Its senior members often participate in deliberations of financial strategies, and are actively involved in high-level decision making. This consideration should be examined in designing a finance function especially as it relates to the appointment of a chief financial officer (CFO).

Service Performance Principle. An effective finance organization is staffed by individuals who are familiar with operations and can work with the line departments to analyze and implement alternative service delivery approaches. Finance staff should be able to apply their cost accounting knowledge to help the service departments measure performance, change practices, and organize efficiently.

Exhibit 1
Attributes of an Effective Finance Structure

Principle	**Organizational Attributes**
Comprehensive scope	• Finance activities should either fall under a finance unit or be subject to its guidance.
Independence	• Maintains the trust and confidence of the public and financial community. • Has the capacity to detect/prevent fraud, waste, and abuse. • Promotes checks and balances.
Accountability	• Exercises financial discipline on government. • Has a clear line of authority and responsibility. • Facilitates meaningful citizen participation in the budget process. • Develops the capacity to carry out adopted policies and programs.
Policy influence	• Provides objective information and advice to decision makers. • Has established standard operating procedures for making and carrying out financial decisions.
Service performance	• Executes decisions and transactions on a timely basis.

	• Has capacity to promote continuous process and policy improvements in other government departments. • Is responsive to department heads' needs and concerns. • Monitors and effectively oversees operating departments' finance operations.
Overhead minimization	• Minimizes duplication and gaps among units in the finance organization. • Minimized administration cost of financial transactions. • Fosters coordination between city-level and departmental finance staff.
Continuous improvement	• Takes advantage of modern information technology. • Adopts best practices from private industry and other governments.

Overhead Minimization Principle. Budgeting and financial management are necessary administrative overhead for the government as a whole. As such, they are particularly vulnerable when efforts are made to streamline government operations. The finance organization should itself be a "lean and mean" operation so that it can have greater credibility in dealing with other government agencies. In addition, finance organizations should seek to reduce the costs of doing business within government.

Continuous Improvement Principle. Like their counterparts in the private sector, government finance organizations should have the capacity to adapt to changes in their external environment. Consequently, reformers should ask what aspects of the organization's design should be institutionalized in city charters, or alternatively in ordinances, rules, and procedures. Governments are operating today in a different technological environment. Advances in information technology may make it possible to simplify organizational procedures while retaining control. Finance organizations must therefore be flexible enough to adopt changes that improve the effectiveness and efficiency of the government as a whole.

These principles are embodied to varying degrees in most government finance organizations. Exhibit 1 identifies specific attributes of an effective finance structure. These attributes can be used to evaluate the performance of the current organization. They can also be used as basis for a "before and after" comparison of organizational changes.

Organizational Design Issues

While American state and local governments have a largely common set of budgeting and financial management functions, they have varied organizational structures for carrying out these activities. Often the differences can be attributed to the size of a jurisdiction. For local governments, the finance function of smaller jurisdictions tends to be headed by a finance director who is responsible for budgeting and a broad range of financial management functions. Separation of duties in order to strengthen internal control is difficult because of the small size of the finance staff. On the other hand, states and large local governments tend to have an elaborate structure combining appointed and elected officials in finance positions. In designing the finance organization, the following issues also need to be addressed:

- elective vs. appointive offices
- legislative oversight and “micro-management”
- the appointment of a CFO
- central vs. departmental finance staffs
- definition of finance functions
- autonomy of enterprise activities.

Elective vs. Appointive Offices. *Are citizens better served by elected or appointed officers?* In some cities, especially large ones, one or more of the offices of the comptroller, auditor, or treasurer are elective. Normally the status of these offices is not open to change through routine reorganizations. If a city is considering charter changes, this can be a major political issue, as any change would disturb the balance of power in city government. Defenders of elective offices can cite higher public visibility and greater political independence and ability to secure resources. Detractors, on the other hand, point to possible headline-seeking behavior and the frequent lack of requirements of professional qualifications in finance for the candidates. The resolution of this issue turns on whether financial accountability is an aspect of political accountability, or is sufficiently equal to it to warrant a fiscal officer directly accountable to voters.

Legislative Oversight and “Micro-Management.” *What is the appropriate role of legislative bodies in financial matters?* In most American cities, the textbook definition of city council acting as a policy-making body is contradicted by the practices of “micro-management,” as evidenced by excessive itemization of the budget and low threshold of budget actions (e.g., transfers) that require council approval. The resolution of this issue requires an agreement on the appropriate sharing of fiscal power. A starting point for a large city might be the proposition that: a) the mayor proposes the budget and the city council makes appropriations subject to mayoral veto; b) subsequently, financial management is entirely an executive function; and c) the city council is empowered to evaluate and audit executive branch performance.

Chief Financial Officer. *Should the entire finance organization be placed under a CFO?* As part of making government more businesslike, some have argued for the appointment of a chief financial officer (CFO), as is the common practice of major corporations. Such a CFO in a large city would generally rank higher than the budget director and the other financial managers, and would report either directly to the mayor or through a chief administrative officer (CAO). This scheme, however, underestimates the political and policy significance of a government’s budget, and the executive’s keen desire to directly control the budget. Indeed, the appointment of a CFO can represent a transfer of power from the political sphere to an administrative one.

Central vs. Departmental Finance Staffs. *To what extent should central finance offices direct departmental finance personnel?* Most city departments of significant size have their own budget and financial management staffs. The reporting relationships between departmental and city level finance staffs therefore becomes problematic. The dilemma is that vertical integration of the finance function requires that the two staffs work together closely. Department heads, however, prefer to have the departmental finance staff be part of their own management team. The resolution of this issue is

Influenced largely by an administration's philosophy toward management decentralization.

Defining "Finance" Functions. *What functions does the finance organization encompass?* There is generally a consensus that the core finance functions—budgeting, accounting, financial reporting, debt, and treasury management—require functional expertise that place them firmly in the finance organization. The same cannot be said for purchasing, risk management, and information systems. These functions have a financial aspect and are related to the core finance functions, but they support city management in general. Smaller jurisdictions tend to combine the related functions into the overall finance organization. By contrast, the large volume of transactions in functions such as purchasing may necessitate a separate department.

Autonomy of Enterprise Activities. *How much autonomy should be granted to enterprise activities and employee pension boards?* Enterprise activities, financed mostly by user fees, have a higher degree of budgetary and operational autonomy than the tax-financed city agencies. The same is true for pension systems, which, because of their fiduciary responsibility and regulatory environment, are subject to less control of their operations by central finance agencies. Nevertheless, they are perceived by the public to be part of the central government. Consequently, legislative bodies often delegate operational control while retaining the prerogative of providing policy guidance.

It is clear from the above discussion that there are often arguments on all sides of the issues of how to organize the finance function of a state or local government. That is the reason why the authors suggest a number of guiding principles at the outset. These principles provide a framework for debating these issues, out of which a compromise may eventually emerge. On the basis of research and a recent in-depth study of a major city, the next section describes a finance organization structure which state and local governments may take as a starting point in redesigning their organizations.

Reorganizing Finance in L.A.

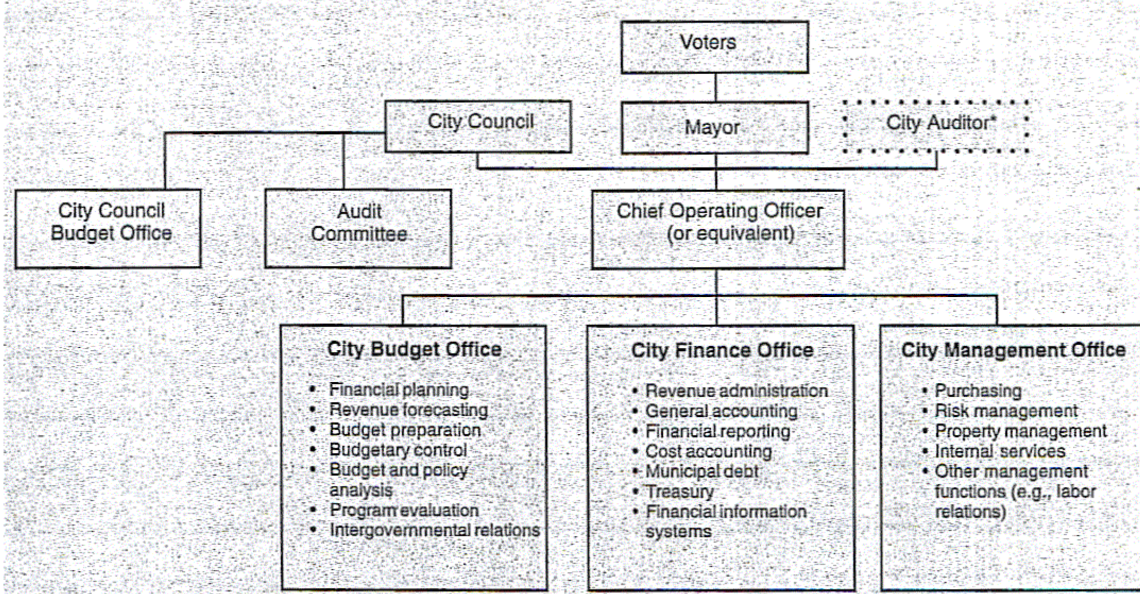
In September 1997 the Research Center of the Government Finance Officers Association of the United States and Canada (GFOA) was commissioned by the City of Los Angeles Charter Reform Commission to study and evaluate alternative organizational models for the finance function for the City of Los Angeles. Subsequently, the Research Center, with the cooperation of the commission staff, conducted interviews with senior city officials and surveyed a larger group of city managers. Additional research was undertaken, including a review of the relevant literature and a survey of several groups of cities—those with a reputation of having "best practices," large California cities, large cities in the Western region, as well as 20 major cities throughout the United States. The goal was to understand the issues surrounding the current institutional structure, obtain factual information about the practices of Los Angeles and other cities, and, after considering the alternatives, propose a design that would help the City of Los Angeles better prepare itself to meet the challenges of the 21st century.

In January 1998, at the conclusion of the research, the GFOA Research Center brought the following problem areas to the attention of the Charter Reform Commission at a public hearing.

• The current structure may not enable city officials to effectively deal with the challenges posed by an environment of declining revenues and fiscal health.
• Lines of fiscal authority are ambiguous. For example, the mayor has appointed a budget director in the mayor's office even though the city administrative officer (CAO) already has budget preparation responsibility; the city treasurer and city clerk both claim revenue collection authority; and the city controller believes his office should conduct performance audits rather than the CAO's office.
• Redundancies and gaps are present which hamper operational efficiency and frustrate efforts to reduce administrative costs. For example, both the city controller and city treasurer are required to maintain separate and duplicate accounting systems.

Some, if not many, of the above concerns could be traced to the current Los Angeles Charter, which disperses fiscal authority among numerous officials on grounds of creating a system of checks and balances. Thus, it is understandable that, as part of the current charter reform effort, an attempt is being made to address these issues so that the City of Los Angeles would have a strong financial management structure to help it better manage its future.

EXHIBIT 2
PROPOSED INTEGRATED FINANCE ORGANIZATION
FOR THE CITY OF LOS ANGELES



* Auditor alternatively could be appointed by City Council

The GFOA Research Center proposed several alternatives for the Charter Reform Commission to consider (Exhibit 2). After weighing the pros and cons, the following recommendations were made to the commission, which are now being deliberated upon.

1) All fiscal officers should be appointed by the mayor subject to city council approval, with the sole possible exception of the city auditor, who may be elected by voters or appointed by the city council. It was felt that the sheer magnitude of fiscal activity for the City of Los Angeles necessitated an independent office that would have as its duties performance auditing and financial auditing of city agencies.

2) The city council should primarily act as a policy-making body on financial matters. Its power should be expressed through the budget approval process and its ability to hold hearings and conduct investigations. Its capacity to scrutinize the executive budget is enhanced by the establishment of a city council budget office. Its oversight authority is increased by the creation of an audit committee. These mechanisms may entice the city council away from micro-management of the policy implementation process.
3) Because of long-standing tradition, the appointment of a CFO was ruled out in favor of a chief operating officer reporting to the mayor. The chief operating officer (COO) would be responsible for integrating budgeting and management and for coordinating all the operating departments on behalf of the mayor. A budget director and finance director would report to the COO.
4) All the city-level finance activities would be conducted through three staff offices, namely
   - a *City Budget Office* that would be responsible for financial planning, budget preparation, and program evaluation;
   - a *City Finance Office* (or finance department) that would be responsible for a full range of financial management functions; and
   - a *City Management Office* that would be responsible for providing general services to city agencies and coordinating the finance-related functions, such as purchasing and risk management. -The three city-level staff offices would be responsible for budget and financial policy formulation. These policies are to be implemented by the departmental finance staffs, which would report to their respective department heads.
5) Municipal enterprise activities, such as water and power, would retain their semi-autonomous status in that they are operationally independent but remain subject to the policy guidance and oversight of the city council and the mayor. The same status applies to employee pension plans. In view of their importance and direct relevance to government finance officers, the recommended major activities of the City of Los Angeles budget and finance offices are enumerated in Exhibit 3. Readers may find this a useful checklist for identifying the coverage of their offices.

Exhibit 3
RESPONSIBILITIES OF PROPOSED CITY OF LOS ANGELES BUDGET AND FINANCE OFFICES

City Budget Office	**City Finance Office**
Financial Planning	Revenue Administration
• Develops the city's financial policies (revenue, expenditure, and debt).	• Develops and implements the city's revenue policy.
• Prepares revenue forecasts.	• Collects revenues from all sources.
• Examines strategic opportunities to increase grants and fees.	• Monitors and reports realization of revenue targets.
• Prepares multiyear financial plans, especially capital improvement plans.	
	General Accounting

• Promotes consistency of multiyear financial plans and annual budgets.
• Coordinates the financial leadership's communication with the credit rating agencies.

Budget Preparation and Control
• Prepares budget guidelines and instructions.
• Reviews departmental budget requests.
• Prepares budget recommendations to the mayor.
• Prepares the mayor's budget proposal to the city council.
• Communicates budget messages to the city's stakeholders.
• Communicates budget allocations to city departments.
• Monitors departmental budget execution.
• Controls employee positions.
• Recommends mid-year budget adjustments.

Budget/Policy Analysis and Program Evaluation
• Develops performance measures and benchmarks.
• Evaluates programs and units during annual budget review.
• Recommends improvements.
• Assesses community needs and priorities.
• Develops and evaluates financial options.

Intergovernmental Relations
• Monitors and assesses the fiscal impact of state and federal policies and actions.
• Coordinates and seeks state and federal grants/funding.
• Pursues initiatives for regional service delivery mechanisms (e.g., city/county cooperation).

• Develops and implements the city's accounting policy.
• Conducts pre-audit and budgetary accounting of expenditures.
• Processes all financial transactions.
• Maintains the city's financial records.
• Consolidates departmental accounts.

Financial Reporting
• Develops and implements the City's financial reporting policy.
• Prepares interim reports.
• Prepares annual reports.
• Prepares legal and contractual compliance reports.
• Consolidates departmental financial reports.
• Cooperates with auditor.

Cost Accounting
• Conducts cost studies of municipal services.
• Recommends cost saving measures.

Municipal Debt
• Develops a debt policy and analyzes debt capacity.
• Manages debt issuance.
• Administers debt service.
• Fulfills disclosure obligations to financial community.

Treasury
• Develops cash management and investment policies.
• Processes cash deposits and disbursements.
• Invests idle cash.

Financial Information Systems
• Maintains and improves city-level financial and purchasing systems.
• Implements sound internal controls in the systems.
• Promotes the integration of all financial

	and purchasing systems. • Maintains interface with departmental systems. • Improves information access by citizens, elected officials, and policy makers.

Conclusion

Almost 50 years ago, Nobel Laureate Herbert A. Simon enunciated the three functions of finance departments: score keeping, attention directing, and problem solving. In a report to the Controllers Foundation that examined the roles of corporate finance departments, he warned that unless they expanded their capabilities and services to increase their usefulness to management in detecting and solving problems, those departments would risk becoming irrelevant or certainly be diminished in importance. His advice was heeded, and the results have been impressive.

During the last 50 years, the finance staffs of corporate America have gained enormous increase in stature and rewards. Corporate finance departments have also become a major source of managerial talents. The authors are suggesting that similar opportunities and challenges face government finance officers and finance departments. Taking advantage of windows of opportunities presented by charter reforms, elections, and organizational changes, they too can reengineer their operations not only to ensure their continuing relevance but also make vital contributions to improve government performance.

Charter reforms, elections, and even smaller-scale management changes provide opportunities to reengineer a government's finance organization. Regardless of the permissible magnitude of change, all such efforts can benefit from a clear definition of principles that increase the effectiveness of the finance organization. The authors suggest that the success of the finance organization, being a staff function, lies in its ability to promote accountability, efficient services, and sound financial decisions. A successful finance organization can be organized in various ways. The organizational form eventually selected depends on the resolution of a number of issues concerning the separation of powers and appropriate checks and balances. It is also likely to be contingent on the size of the jurisdiction and the magnitude of fiscal activity. The structure described in this article illustrates how these issues might be resolved in the City of Los Angeles. This model may be adopted or adapted in light of a state or local government aspirations to achieve its vision for the future.

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