

PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA



Report

Review of Auditor-General's Reports 1993-94
Accrual Reporting

MAY 1995

Joint Committee of Public Accounts

The Parliament of the Commonwealth of Australia

Joint Committee of Public Accounts

REPORT 338

Accrual Accounting - A Cultural Change

August 1995

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MEMBERSHIP OF THE COMMITTEE

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Mr A M Somlyay, MP (Vice-Chairman)¹

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Mr C D Haviland, MP

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Mr M A J Vaile, MP

Secretary: Mr G Harrison

1. Vice-Chairman from 29 June 1994
2. Discharged 9 June 1994
3. Appointed 29 June 1994
4. Discharged 29 June 1994

MEMBERSHIP OF THE
SECTIONAL COMMITTEE ON
AUDITOR-GENERAL'S REPORTS⁵

Mr L J Scott, MP (Chairman)

Senator B Gibson

Mr E J Fitzgibbon, MP

Mr A P Griffin, MP

Mr C D Haviland, MP

Mr A M
Somlyay, MP

Mr W L Taylor, MP

Mr M A J Vaile, MP

Secretary: Dr J Carter

Inquiry Staff: Ms J Hughson
Ms D Christophers
Ms L Gillies

5. The Sectional Committee on Auditor-General's Reports was responsible for the conduct of the review of accrual reporting and accounting in Commonwealth agencies.

DUTIES OF THE COMMITTEE

The Joint Committee of Public Accounts is a statutory committee of the Australian Parliament, established by the *Public Accounts Committee Act 1951*.

Section 8(1) of the Act describes the Committee's duties as being to:

- examine the accounts of the receipts and expenditure of the Commonwealth including the financial statements transmitted to the Auditor-General under sub-section (4) of section 50 of the *Audit Act 1901*;
- examine the financial affairs of authorities of the Commonwealth to which this Act applies and of inter-governmental bodies to which this Act applies;
- examine all reports of the Auditor-General (including reports of the results of efficiency audits) copies of which have been laid before the Houses of the Parliament;
- report to both Houses of the Parliament, with such comment as it thinks fit, any items or matters in those accounts, statements and reports, or any circumstances connected with them, to which the Committee is of the opinion that the attention of the Parliament should be directed;
- report to both Houses of the Parliament, any alteration which the Committee thinks desirable in the form of the public accounts or in the method of keeping them, or in the mode of receipt, control, issue or payment of public moneys; and
- inquire into any question in connexion with the public accounts which is referred to it by either House of the Parliament, and to report to that House upon that question.

The Committee is also empowered to undertake such other duties as are assigned to it by Joint Standing Orders approved by both Houses of the Parliament.



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LIST OF ABBREVIATIONS

AAS 29	Australian Accounting Standard 29 - Financial Reporting by Government Departments
ABS	Australian Bureau of Statistics
ANAO	Australian National Audit Office
AARF	Australian Accounting Research Foundation
COAG	Council of Australian Governments
CSIRO	Commonwealth Scientific and Industrial Research Organisation
DEET	Department of Employment, Education and Training
FASAB	Federal Accounting Standards Advisory Board (US)
Finance	Department of Finance
FMIP	Financial Management Improvement Program
GFS	Government Financial Statistics
MAB	Management Advisory Board
PSC	Public Service Commission
SES	Senior Executive Service
the FMA Bill	Financial Management and Accountability Bill 1994

CHAIRMAN'S FOREWORD

Since 1989, secretaries of Commonwealth departments have been required to include audited financial statements in their annual reports. These statements are prepared in accordance with guidelines issued by the Minister for Finance, and in the years since 1989 the guidelines have required information:

- on receipts and payments against budget for each of the Commonwealth's funds and for each agency program; and increasingly
- on a range of assets and liabilities.

In 1992 the then Minister for Finance, the Hon Ralph Willis MP, announced that the financial reporting framework for Commonwealth agencies would be recast to reflect accrual accounting concepts. The effect of this is that from 1994-95 the annual financial statements of all Commonwealth agencies will recognise revenues, expenses and the full range of assets and liabilities managed by the agency.

The change from cash based reporting to accrual based reporting is part of a broader public sector reform process, one element of which is to improve public sector efficiency and effectiveness by introducing aspects of commercial business practice.

The new framework for financial reporting also reflects the fact that traditional notions of public sector accountability have changed and that governments and agency managers should be accountable for more than just cash flows and balances. The nature of public sector accountability has shifted from a narrow focus on compliance with spending limits to embrace accountability for outputs, efficiency and results of activities; to encompass concerns about the full cost of operations; and to consider longer terms obligations and overall financial position.

This report is the result of the Committee's review of two reports presented to the Parliament by the Auditor-General in 1994. The reports were *Audit Report No. 32, 1993-94, Efficiency Audit, Accrual Reporting - Are Agencies Ready?* and *Audit Report No. 16, 1994-95, Follow-up Audit, Accrual Reporting - Are Agencies Ready?*. The audit reports contained an assessment of whether agencies were adequately prepared to meet their reporting obligations.

As well as taking evidence on the readiness of agencies to produce accrual based financial statements for 1994-95, the Committee considered the further issue of how accrual information can be used (by the Government, by agency managers and by external reviewers) to make better judgements about operating performance, economic impact and the stewardship of public resources.

The Committee believes that accrual information is an essential tool for modern public sector management. Without regular access to accrual information it is not possible to make accurate assessments of the cost of service provision, and thereby the efficiency of program performance. It is of concern to the Committee that as yet only a few agencies have recognised the value of accrual information, and even fewer have taken the initiative to explore the full potential of accrual information. There is a danger that the reform process will stall unless the Government sets new targets beyond accrual reporting.

The Government should articulate a clear vision for the future of financial reporting in the Commonwealth, incorporating whole of government reporting, accrual management and, possibly, accrual based budgeting.

A statement of direction from the Government would give great impetus to the tentative steps being taken by agencies toward accrual accounting and accrual management.

At an agency level, accrual based financial management systems should be introduced and more should be done to educate managers in how to make best use of accrual information.

It is important also that external receivers, including parliamentarians, know how to use accrual information in assessing agency performance and holding managers to account for their

use of public resources.

The recommendations in this report address these issues and are intended to help generate a new momentum in the reform process.

In conclusion, and on behalf of the Committee, I would like to express our appreciation to those people who contributed to the review by preparing submissions and giving evidence at public hearings. I would particularly like to thank those private citizens and State Government officials who gave freely of their time and expertise, and staff at the New Zealand High Commission who provided much useful information. I would also like to thank George Carter, from the Department of Finance, and Malissa Golightly, from the Australian National Audit Office, who acted as observers during the course of the Committee's review.

Les Scott, MP
Chairman

RECOMMENDATIONS

Recommendation 1

The Department of Finance should:

- (a) develop a professional marketing strategy directed at potential users of agency financial statements and with the aim of promoting the use which can be made of the accrual based information contained in financial statements;
- (b) as part of the marketing strategy, distribute its publication *The New Financial Reports of Agencies* widely within the target group of people who may use agency financial statements, including - Ministers and their staff, parliamentarians and their staff, senior public service managers, internal auditors and program evaluators, peak industry and community groups, industry regulators, key economic and policy analysts, and the media;
- (c) as part of the marketing strategy, prepare and distribute widely information/promotional brochures containing extracts from *The New Financial Reports of Agencies* and examples of how accrual information can and has been used; and
- (d) coordinate these activities with the tabling in Parliament of the 1994-95 annual reports of Commonwealth agencies. (paragraph 4.37)

Recommendation 2

The Departments of the Senate and the House of Representatives, in conjunction with the Department of Finance, should develop information and training packages on the new financial reports of agencies for parliamentarians and parliamentary staff. (paragraph 4.38)

Recommendation 3

The Department of Finance should:

- (a) amend the Financial Statement Guidelines for Departmental Secretaries and the Financial Statements of Commonwealth Authorities to require Chief Executives to include in their financial statements a range of tables and charts, based on key performance ratios, highlighting significant information contained in the statements;
- (b) prepare, for the guidance of agencies, a number of sample charts and tables based on key performance ratios; and
- (c) collect, analyse and table in Parliament on an annual basis a consolidated series of charts and tables comparing the performance of all Commonwealth agencies against a range of key performance ratios. (paragraph 4.52)

Recommendation 4

The Department of Finance should further refine its training strategy to:

- (a) include less of a focus on preparing accrual reports and more of a focus on using accrual information as a management tool; and
- (b) include specifically tailored courses and material for senior executive officers. (paragraph 6.15)

Recommendation 5

The Government should consider:

- (a) providing supplementary funding to agencies to help them redevelop their financial management systems so as to provide full accrual accounting functionality; and
- (b) making interest free loans available to agencies to help in the transition from cash based accounting systems to accrual based accounting systems; (paragraph 6.27)

Recommendation 6

The Department of Finance should:

- (a) consider sponsoring a joint working party to examine and make recommendations about appropriate financial management information systems for small and medium sized agencies; and
- (b) facilitate meetings of agencies with similar characteristics with the aim of encouraging the agencies to share the costs of implementing new financial information systems by pooling their research and development resources in a joint pilot project. (paragraph 6.28)

Recommendation 7

The Office of Government Information Technology should expedite work on the review of Commonwealth personnel and financial management systems and take account of the need for full accrual accounting functionality in any integrated management system proposed by the review group. (paragraph 6.29)

Recommendation 8

The Department of Finance should consider the appropriateness of levying a charge on agencies for the public assets they hold and use, as a means of encouraging agencies to properly value and efficiently manage their assets. (paragraph 6.41)

Recommendation 9

The Government should commission a major review of the Commonwealth's system of budget appropriations to consider the merits or otherwise of altering the system to require that budgets be prepared and appropriations be made on an annual basis. (paragraph 6.80)

Recommendation 10

The Government should make a statement stressing the value of accrual information as an aid to effective management of public resources and supporting the move toward full accrual accounting for Commonwealth agencies. (paragraph 6.88)

Recommendation 11

All agency heads should:

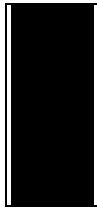
- (a) commit themselves and their agencies to the implementation of accrual management systems and practices; and
- (b) prepare detailed implementation plans to guide the development of accrual management systems and practices in their agencies - including statements of systems redevelopment requirements, staff training requirements, and target dates for the achievement of key milestones. (paragraph 6.89)

Recommendation 12

The Government should commit itself to the preparation, at least annually, of whole of government reports for the Commonwealth. (paragraph 7.39)

Recommendation 13

At the same time as announcing a commitment to prepare whole of government reports, the Government should announce an implementation plan incorporating target dates for the achievement of key milestones. (paragraph 7.48)



APPENDIX I - SUBMISSIONS

Submissions¹

80	Department of Social Security
86	Attorney-General's Department
87	Commonwealth Superannuation Administration (COMSUPER)
90	Department of Defence
99	Department of Prime Minister and Cabinet
101	Department of Environment, Sport and Territories
103	Department of Immigration and Ethnic Affairs
108	Department of Employment, Education and Training
109	Department of Communications and the Arts
110	Department of Finance
112	Department of Administrative Services
116	Department of Industry, Science and Technology
118	Department of Primary Industries and Energy
119	Department of Human Services and Health

1 The submissions were extracted from those submitted for the Review of all 1993-94 audit reports. Consequently submissions which do not relate to the accrual reporting inquiry are not listed.

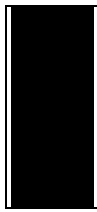
-
- 121 Department of Veterans' Affairs
- 122 Department of Foreign Affairs and Trade
- 124 Australian Taxation Office
- 148 Auditor-General for Tasmania
- 150 Auditor-General's Department of South Australia
- 151 Australian National Audit Office
- 152 The Audit Office of New South Wales
- 153 Office of the Auditor-General of Western Australia
- 154 Mrs Cecilia Spence and Professor Brian Andrew,
University of Canberra
- 155 Department of Finance
- 156 Macquarie University, Sydney
- 157 Mr Ian McAuley, University of Canberra
- 158 The Audit Office of New South Wales
- 159 Auditor-General of Queensland
- 160 The Australian Society of Certified Practising
Accountants and the Institute of Chartered Account-
ants in Australia
- 161 Department of Finance, Victoria
- 162 The Treasury of Western Australia
- 163 The Institute of Internal Auditors - Australia, Canberra
Branch
- 164 Auditor-General for the Northern Territory

- 165 Northern Territory Treasury
- 166 Department of Treasury and Finance, Tasmania
- 167 Ernst & Young
- 168 Department of Defence
- 169 Department of Employment, Education and Training
- 170 Dr Robert Albon, Australian National University
- 171 Australian Bureau of Statistics
- 172 Department of Human Services and Health
- 173 The Institute of Chartered Accountants in Australia,
and Australian Society of Certified Practising Ac-
countants
- 176 Department of the Treasury
- 177 Department of Employment, Education and Training
- 178 Australian Accounting Research Foundation
- 179 Department of Human Services and Health
- 180 CSIRO
- 181 Australian Accounting Research Foundation
- 183 Australian Bureau of Statistics
- 184 Attorney-General's Department
- 185 Department of the Treasury
- 186 Department of Finance
- 187 Department of Administrative Services
- 188 Department of Finance

189 The Treasury of Western Australia

Submissions from the Australian National Audit Office

A21 Australian National Audit Office



APPENDIX II - EXHIBITS

Exhibits¹

- 4 Royal Institute of Public Administration Australia
- 5 The Treasury of New South Wales
- 6 Ernst & Young - 'Accrual Accounting in the Public Sector: A National Survey'
- 7 New Zealand High Commission
- 8 New South Wales Treasury
- 9 New Zealand High Commission
- 10 Australian Accounting Research Foundation
- 11 Australian Accounting Research Foundation - 'Financial Reporting by Governments'
- 12 Department of Finance - 'Accounting for What?: The Value of Accrual Accounting to the Public Sector'
- 13 Dr Robert Albon, ANU - 'A Journal of Policy Analysis and Reform'
- 14 Dr Robert Albon, ANU - 'Evaluating Changes in a Government's Net Economic Position'
- 15 Coopers & Lybrand - 'Internal Control: Should There be Public Reporting?'

1 The exhibits were extracted from those submitted for the Review of all 1993-94 audit reports. Consequently exhibits which do not relate to the accrual reporting inquiry are not listed.

-
- 16 Department of Treasury and Finance, Victoria - 'Recognition and Valuation of Non-Current Physical Assets'
 - 17 Department of Employment, Education and Training - 'Bridging the Gap: Accrual Accounting, No. 1, December 1993 and No. 2 May 1994'; and 'Introduction to Accrual Accounting'
 - 18 Victorian Public Accounts and Estimates Committee - 'Reinventing Government: Lessons Learned from the New Zealand Treasury'
 - 19 Victorian Public Accounts and Estimates Committee - 'Pre-Budget Media Briefing on Advantages of Accrual Accounting'
 - 20 Victorian Public Accounts and Estimates Committee - 'Opening and Balancing the Books, the New Zealand experience'
 - 21 Victorian Public Accounts and Estimates Committee - 'Making Ministries More Accountable: the New Zealand experience'
 - 22 Victorian Public Accounts and Estimates Committee - 'Implementing Accrual Accounting in the Public Sector - the New Zealand experience'
 - 23 Victorian Public Accounts and Estimates Committee - 'letter to Mr Bradford, MP, Chairman, Finance and Expenditure Committee, New Zealand from Lyn Provost, Assistant Auditor-General, New Zealand'
 - 24 Victorian Public Accounts and Estimates Committee - 'Finance and Expenditure Committee - Financial Review Questionnaire 1993-94'

- 25 Victorian Public Accounts and Estimates Committee - 'Speech to the Australian Standing Treasuries Liaison Committee, The New Zealand Experience with Accrual Reporting'
- 26 Victorian Public Accounts and Estimates Committee - '1992: Report on Performance Audit of the Auditor-General of Victoria Pursuant to Section 48B of the Audit Act 1958'
- 27 Department of Treasury and Finance, Victoria - 'Business Plan 1994/95, Department of Finance (Vic)'; 'Corporate Plan 1993/94 - 1995/96, Department of Finance (Vic)'; and 'Annual Report 1993/1994, Department of Finance (Vic)'
- 28 Office of the Controller and Auditor-General, New Zealand - 'Putting it Simply - an explanatory guide to Financial Management Reform'
- 29 Office of the Controller and Auditor-General, New Zealand - 'The Audit Office - Report on The Audit of the Crown and Government Departments, for the year ended 30 June 1992'
- 30 Office of the Controller and Auditor-General, New Zealand - 'The Audit Office - Report on The Audit of the Crown and Government Departments, for the year ended 30 June 1991'
- 31 Office of the Controller and Auditor-General, New Zealand - 'Report of The Controller and Auditor-General, Second Report for 1993'
- 32 Office of the Controller and Auditor-General, New Zealand - 'Presentation to the Joint ASCPA/RIPAA Seminar, Hobart, "The New Zealand Experience with Accrual Budgeting, Accounting and Reporting"'
- 33 Office of the Controller and Auditor-General, New Zealand - 'Economic and Fiscal Outlook 1994'

-
- 34 Office of the Controller and Auditor-General, New Zealand - 'Central Government Management, A New Approach'
- 35 Department of Finance - 'Financial Statements of Departments: Guidelines issued by the honourable Kim C Beazley, Minister for Finance, for reporting periods ending on and after 30 June 1995'
- 36 Australian Bureau of Statistics - 'Introduction of an Accruals Basis in Government Finance Statistics'
- 37 Department of Finance - 'The New Financial Reports of Agencies - a guide to the use of accrual accounting and reporting by Commonwealth Agencies'
- 38 The Treasury - 'The Treasury: Annual Report 1993-94'
- 39 The Treasury - 'Treasury, Financial Statement, Accounting and Finance Directorate 1993-94'
- 40 Public Sector Accounting Standards Board of the Australian Accounting Research Foundation - 'Financial Reporting by Governments''
- 41 Department of Finance - 'Accounting and Financial Reporting in the Public Sector'
- 42 Department of Finance - 'Report on Whole-of-Government Financial Reporting'
- 43 Department of Finance - 'Federal Government Reporting Study, A Joint Study by the Office of the Auditor-General of Canada and the United States General Accounting Office'
- 44 Department of Finance - 'notes provided by the Department'

- 45 Department of Finance - 'Presentation to the Australasian Area Auditors-General, Hobart - Whole of Government Reporting'
- 46 Department of Finance - 'Federal Accounting Standards Advisory Board - Managerial Cost Accounting Standards for the Federal Government - Statement of Recommended Accounting Standards - Exposure Draft, October 1994'
- 47 Department of Finance - 'Resource Management Systems - An Efficiency Unit Scrutiny - May 1995'
- 48 Industry Commission - 'Media Release - Review of Commonwealth and State Government Service Provision'
- 49 Department of Finance - 'Suite of Accrual Training Courses offered by the Department of Finance'
- 50 Federal Accounting Standards Advisory Board - *FASAB soon to complete basic work, in FASAB News Issue No. 31, May 1995*
- 51 Department of Finance - 'Employee Support Costs 1993/94'

Confidential Exhibit

The Committee received one confidential exhibit as part of its inquiry.



APPENDIX III - WITNESSES AT PUBLIC HEARINGS

Monday, 13 February 1995

Australian National Audit Office

Mr Bill Nelson, Acting Auditor-General

Mr Russell Chantler, Executive Adviser, Technical Support

Mr Warren Cochrane, Acting National Business Director,
Performance Audit

Miss Malisa Golightly, Executive Director, Performance Audit

Department of Finance

Mr Pat Barrett, Deputy Secretary

Mr George Carter, Special Adviser, Accounting

Mr Michael Darcy, Director, Accounting Development
Section

Mr Dean Wallace, Assistant Secretary, Public Administration
and Accounting Development Branch, Financial Management
Division

Australian Society of Certified Practising Accountants and Institute of Chartered Accountants

Mr Michael McKenna, Executive Director

Mr Ian McPhee, Chairman, Public Sector Accounting Standards Board

Mr Keith Reilly, Director, Technical Standards, Institute of Chartered Accountants in Australia

Mr Paul Sutcliffe, Director, Accounting Practice, Australian Accounting Research Foundation

Ernst & Young

Mr Geoffrey Applebee, Partner

Mr Brian Kimball, Senior Manager

Mrs Jennifer Morison, Senior Manager

University of Canberra

Professor Brian Andrew, Head, School of Accounting and Finance

Professor John Halligan, Director

Mrs Cecilia Spence, Senior Lecturer in Accounting

Tuesday, 21 February 1995

New South Wales Audit Office

Mr Steven Fryer, Senior Audit Manager

Mr Anthony Harris, Auditor-General for New South Wales

Mr Jack Kheir, Director of Audit

New South Wales Treasury

Mr Michael Lambert, Secretary

Mrs Thuy Mellor, Executive Director, Accounting and Financial Policy

Private Citizens

Professor David Fraser
(University of Technology, Sydney)

Professor Carrick Martin
(Macquarie University, Sydney)

Monday, 10 April 1995*Victorian Department of the Treasury and Finance*

Mr Frank King, Deputy Secretary

Mr Ronald Paice, Comptroller-General

Victorian Auditor-General's Office

Mr Russell Walker, Assistant Auditor-General

Mr Steven Mitsas, Director

Mr Remy Szpak, Audit Manager

Coopers & Lybrand

Mr Kevin Stevenson, National Technical Partner, Business
Assurance Services

Private Citizen

Professor Robert Officer
(former Chairman of Victorian Commission of Audit)

Wednesday, 12 April 1995*Department of Employment, Education and Training*

Dr Trish Mercer, Acting First Assistant Secretary, Corporate
Services Division

Mr Neil McAuslan, Director, Financial Policy and Accrual
Accounting

Department of Human Services and Health

Mr Andrew Gregory, Assistant Secretary, Audit and
Payments Control

Mrs Sue Hamilton, Assistant Secretary, Financial Manage-
ment

Mr Douglas Mitchell, Assistant Director, Corporate Financial Systems and Reporting

Mr Allan Rimington, Director, Corporate Financial Systems and Reporting

Department of Defence

Mr Anthony Ayers, Secretary

Mr Frances Harvey, Inspector-General

Mr Phillip Huntley, Senior Assistant Secretary, Financial and Accounting Management

Mr Robert Tonkin, First Assistant Secretary, Resources and Financial Programs

Australian Bureau of Statistics

Mrs Coleen Abbey, Assistant Director, Financial Management Section

Ms Irene Griffiths, Director, Financial Management Section

Mr Abdul Khan, Director, Management Accounting Section

Mr Ivan King, Assistant Statistician, Corporate Strategy Branch

Dr Richard Madden, Deputy Australian Statistician

Monday, 22 May 1995

Department of the Treasury

Dr Alan Preston, Acting Secretary to the Treasury

Ms Jennifer Aked, Director, Accounting and Finance

Mr Peter Luxford, Financial Accountant/Project Officer

Australian Accounting Research Foundation

Mr Ian McPhee, Chairman, Public Sector Accounting Standards Board

Mr Frank Micalleff, Senior Project Director, Accounting

Australian National Audit Office

Mr Pat Barrett, AM, Auditor-General

Mr Warren Cochrane, Acting National Business Director, Performance Audit

Ms Malisa Golightly, Executive Director, Performance Audit

Mr Edward Hay, Acting National Business Director

Ms Lynn O'Brien, Acting Executive Director, Financial Audit Business Unit

Department of Finance

Mr Phil Bowen, First Assistant Secretary, Financial Management Division

Mr George Carter, Special Adviser, Accounting

Mr Michael Darcy, Director, Accounting Development Section

Miss Wendy Hordern, Director, Resource Reporting and Analysis Section

Mr Dean Wallace, Assistant Secretary, Public Administration and Accounting Development Branch, Financial Management Division



APPENDIX IV - AN ILLUSTRATIVE FRAMEWORK OF THE APS REFORMS

Introduction

The following information is taken from *The Australian Public Service Reformed*¹ which describes the changes in the APS over the past decade.

Structural Reforms

- 1 **Changes in the machinery of government** [the structure of APS agencies has changed to reflect the composition of the Government]

- 2 **Organisational reform** [agencies' structures have been reorganised to better reflect programs and office arrangements and have incorporated a flatter structure]

- 3 **Devolution** [financial and personnel decision-making capacity has been transferred from higher levels to lower levels]

- 4 **Decentralisation** [functions or tasks have been redistributed from central units to more dispersed units]

Industrial Reforms

- 5 **Formal consultative mechanisms** [agencies have introduced organised arrangements for consultation with staff and unions]

1 *The Australian Public Service Reformed*, MAB, pp. 61-3.

- 6 **Permanent part-time work** [agencies have introduced arrangements providing part-time work opportunities]
- 7 **Streamlining of classifications** [award structures have been reorganised to reflect modern, competitive requirements]

Human Resource Management Reforms

- 8 **Performance appraisal** [agencies have introduced systems for the evaluation of staff skills and work]
- 9 **Equal employment opportunity** [agencies have introduced programs to eliminate employment discrimination against people in target groups]
- 10 **Occupational health and safety** [agencies ensure that the workplace is healthy and safe]
- 11 **Career planning** [agencies have introduced strategies to help staff achieve desired levels of professional achievement]

Financial Management and Budgeting Reforms

- 12 **Forward estimates** [in the absence of further decisions, allocations to agencies result from their published three year financial estimate of operational resource requirements]
- 13 **Running costs** [agencies receive a single allocation covering salaries and administrative expenses (current cost) for delivery of the government programs and services for which they are responsible]
- 14 **Efficiency dividend** [agencies are required to achieve general efficiency improvements to cover an annual decrease in the funds allocated to them (currently 1.25 per cent p.a.)]
- 15 **Resource agreements** [agreements can be made between agencies and Finance for the provision of resources, usually over an extended period, in return for specific

action to increase efficiency and effectiveness]

- 16 **Program management and budgeting** [agencies' budgets are prepared on a program basis with a process which focuses on assessment of program effectiveness (and efficiency) against defined objectives rather than solely controlling resource inputs]
- 17 **Portfolio budgeting** [responsibility is placed on portfolios to manage their program activities within an approved target level of resources; this often requires some reductions in resources but allows flexibility for minor new policy and for other changes in the deployment of resources within portfolios]

Commercial Reforms

- 18 **User charging** [agencies are able to employ the user pays principle by which users rather than the central budget are expected to bear all or part of the cost of a particular activity]
- 19 **Contracting** [agencies can contract out activities to the private sector or other agencies, or contract in by undertaking work for others]
- 20 **Accrual accounting** [revenues and expenses are presented for the period to which they relate]
- 21 **Corporatisation** [corporations and government business enterprises have been created]

Planning and Reporting Reforms

- 22 **Corporate plans** [agencies' plans now include goal statements]
- 23 **Program performance statements** [agencies identify descriptions and objectives for programs and established efficiency/effectiveness performance indicators to enable the minister to report to parliament]
- 24 **Evaluations** [agencies now have a formal policy and

cycle for evaluating performance of all programs and for taking account of findings]

- 25 **Management information systems** [agencies have introduced a system which provides relevant and timely information, meets the needs of work areas and can be used to monitor results and resource use]
- 26 **Annual reports** [agencies now report on the activities undertaken to meet program objectives]



APPENDIX V - RATIOS FOR COMPARISONS OF PERFORMANCE

Introduction

The information contained in accrual-based financial reports is presented in such a way as to facilitate comparisons between reporting periods and between different entities. This means it is comparatively easy to establish trends and identify performance benchmarks. A comparison of ratios over time could be an important way of highlighting best practice or trends and calling agencies to account for departures from these marks. The following ratios have been taken from the Finance publication, *The New Financial Reports of Agencies*¹.

Financial Performance

The following table provides examples of ratios that may assist in making assessments of financial performance, including the efficiency of administration. The ratios marked * can be adapted for other programs.

<i>SELF-SUFFICIENCY</i> $\frac{\text{Revenues from independent sources} \times 100}{\text{Total operating expenses}}$	Shows the reduction in budget dependency resulting from user charges and asset sales.
<i>GOVERNMENT FUNDING</i> $\frac{\text{Revenues from government} \times 100}{\text{Net cost of services}}$	Shows the extent to which the net cost of producing goods and services is funded by government.
<i>TAX ADMINISTRATION COSTS *</i> $\frac{\text{Net cost of services}}{\text{Number of tax returns}}$	Shows the net annual administration cost for each tax return.

1 Exhibit No. 37, pp. 49, 53 and 55.

<p><i>BENEFITS ADMINISTRATION COSTS *</i></p> <p><i>Net cost of services</i></p> <p><i>Number of benefit payments</i></p>	<p>Shows the net annual administration cost for each benefit payment (e.g. payments for pensions, unemployment, etc.)</p>
<p><i>AVERAGE EMPLOYEE COSTS</i></p> <p><i>Employee expenses</i></p> <p><i>Average number of employees</i></p>	<p>Shows the average annual employee cost (including accrued entitlements).</p>
<p><i>EMPLOYMENT SUPPORT COSTS</i></p> <p><i>Administration expenses</i></p> <p><i>Average number of employees</i></p>	<p>Shows the annual administration cost for each employee (e.g. rent, power, depreciation of plant and equipment etc.)</p>
<p><i>RATE OF CHANGE</i></p> <p><i>Change in item or total x 100</i></p> <p><i>Previous year item or total</i></p>	<p>Highlights material changes in the amounts of items that may warrant further inquiry (e.g. above a particular threshold).</p>
<p><i>CHANGE IN COMPOSITION</i></p> <p><i>Change in % item to total</i></p>	<p>Highlights material changes in the composition of revenues and expenses that may warrant further inquiry.</p>

Financial Position

The following ratios are based on information that may be derived from the Statement of Assets and Liabilities. They may be especially useful in assessing the extent to which excessive resources may be locked into receivables and inventories because of poor asset management practices. The items marked * may require unpublished information.

TRADE DEBTORS <i>Average trade debtors x 365</i> <i>Total credit sales *</i>	Shows the average number of days that trade debtors are outstanding during the year.
DAYS INVENTORIES HELD <i>Average inventories x 365</i> <i>Inventories sold or used *</i>	Shows the average number of days that inventories are held prior to sale or use.
PROGRAM RECEIVABLES <i>Average program receivables x 365</i> <i>Program revenues *</i>	Shows the average number of days that program receivables are outstanding during the year (e.g. tax receivables).
OVERPAYMENTS <i>Average overpayments receivable x 365</i> <i>Overpayments identified *</i>	Shows the average number of days that receivables for overpayments are outstanding during the year.
EMPLOYEE ENTITLEMENTS <i>Employee benefits payable</i> <i>Number of employees</i>	Shows the average liability for employee benefits per employee at the end of the financial period.
RATE OF CHANGE <i>Change in item or total x 100</i> <i>Previous year item or total</i>	Highlights material changes in the amounts of items that may warrant further inquiry (e.g. above a particular threshold).
CHANGE IN COMPOSITION <i>Change in % item to total</i>	Highlights changes in the composition of assets and liabilities that may warrant further inquiry.

Cash Flow Ratios

The following ratios can be used to make detailed assessments of the way an agency has used its cash during a financial year.

<p><i>FUNDING OF SERVICES</i> <i>Cash provided by Government</i> <i>Net cost of services</i></p>	Shows the extent to which cash is provided for net agency costs.
<p><i>REINVESTMENT</i> <i>Purchases of assets</i> <i>Net cash from operations</i></p>	Shows the proportion of net cash from operations reinvested in assets.
<p><i>DEPRECIATION IMPACT</i> <i>Depreciation</i> <i>Net cash from operations</i></p>	Shows the proportion of net cash from operations that may need to be reinvested in assets over time.
<p><i>REINVESTMENT SUFFICIENCY</i> <i>Reinvestment ratio</i> <i>Depression impact ratio</i></p>	Shows sufficiency of reinvestment and maintenance of asset base (generally a ratio in excess of one would be desirable).
<p><i>RATE OF CHANGE</i> <i>Change in item or total x 100</i> <i>Previous year item or total</i></p>	Highlights material changes in the amounts of items that may warrant further inquiry (e.g. above a particular threshold).
<p><i>CHANGE IN COMPOSITION</i> <i>Change in % item to total</i></p>	Highlights changes in the composition of cash inflows and outflows that may warrant further inquiry.



APPENDIX VI - CASE STUDIES

Introduction

The following case studies were supplied by the Attorney-General's Department, ABS, and CSIRO.¹

The agencies were requested to provide brief case studies of their activities which revealed the benefits of accrual concepts which could be directly applicable to agencies which are non-commercial in their orientation.

Attorney-General's Department

The Attribution of the Full Costs to Outputs

The Attorney-General's Department introduced accrual accounting in the 1992-93 financial year. The decision to introduce accrual accounting was taken as a consequence of the introduction of user pays for the Legal Practice element of the Department, however the Department also took the opportunity to prepare its financial statements on the full accrual basis for the 1992-93 financial year as part of the pilot program announced by the Minister for Finance.

The Department considers that it has gained considerable additional information which has enabled it to focus to a much greater level on outputs rather than inputs because the complete cost of providing services is now available to all program managers, resulting in a higher level of accountability and more informed decision making processes.

As stated earlier, it was important, in terms of establishing fee schedules and appropriate rates of return, that the Legal Practice

1 Attorney-General's Department, *Submission*, pp. S1993-4;

ABS, *Submission*, pp. S1990-2; CSIRO, *Submission*, pp. S1975-6.

was able to identify the full cost especially the costs associated with the consumption of assets, ie depreciation, in providing legal services. Had the Legal Practice been unaware of the full cost of providing services, it would have been unable to structure a fee schedule which would ensure full cost recovery and the provision of funds to enable the timely replacement of assets.

In moving to accrual accounting and attributing costs to program managers, one of the key elements has been the apportionment of costs of corporate services and the inevitable forces to drive these costs down as program managers seek to ensure cost-effective service delivery. Obviously the pressure to reduce costs is greater within those areas participating in a cost recovery or commercialised activity.

The introduction of accrual accounting, and more importantly accrual reporting on a monthly basis, has heightened awareness of the real cost of providing services and the opportunity to take corrective action at the earliest point in time.

The Department has applied accrual accounting procedures in undertaking a number of reviews and areas which are predominantly Budget-funded are seeking provision on a monthly basis of accrual and cash reports.

The Department undertook the systems design, implementation and training internally. We consider that this was an important decision as it focussed our resources and retained the knowledge and experience within the Department. The training we introduced was undertaken on a need-to-know basis, ie those staff involved in decision-making were provided with training on the differences between cash and accrual information. Training was not provided for staff who were not affected by the movement from cash to accrual.

Accrual accounting has been crucial in the management of the Attorney-General's Department's finances. It has provided management with much more relevant information for decision making and has increased accountability of line managers for their actions.

Australian Bureau of Statistics

Management of IT Resources

The growing demand for Information Technology (IT) services and facilities and the consequent resource implications led the ABS senior management to introduce an internal cost recovery regime in 1989/90. The principal objective was to rationalise demand for IT and to encourage managers to search for the optimum mix of resources in reaching their work objectives.

The prices for IT products and services had to be based on the concept of recovery of the *expenses* of the IT operations over the medium term, not the annual *cash outlays*. This is because *inter alia* cash outlays include capital expenditure and it is inappropriate to recover these costs in one year. In this sense the determination of the expenses of the IT operations inevitably required the application of accrual accounting principles. As the ABS in common with other APS agencies was subject to cash accounting rules until recently, this created anomalies and tensions in the price setting process. The problems included the unavailability of relevant information, such as depreciation, prepayments and accrual liabilities, from the official accounting system and consequent reliance on subsidiary systems and/or estimates. This in turn led to confusion and lack of understanding and agreement of the bases on which prices were set and the extent to which such prices achieved the objective of recovering IT expenses over the medium term.

Converting the whole of the ABS accounting system in 1993/94 to the accrual basis facilitated the adoption of an accrual based planning and budgeting approach for the IT operations which involves budgeting for operating and capital expenditure as well as cash flows - separately but within an integrated framework. The operating budget shows the projected expenses and revenues of the cost recovery operations and therefore allows the reasonableness of the prices to be assessed. A separate cash budget facilitates the assessment of the cash requirements of the IT operations which may differ, sometimes significantly, from the operation result because of such factors as differences between capital expenditure and depreciation. Separate capital budgets highlight proposed capital expenditure which needs to be assessed based on longer term considerations. We do not claim to have resolved all our difficulties in this area but we believe that we are moving in the right direction.

Asset Recognition and Assessment of Costs

Statistical systems and databases are an essential part of the ABS' operations. Many of these systems are developed in-house and significant amounts of resources are sometimes involved in such development. Under cash accounting these expenditures, in common with all other cash expenditure, were written off as they were incurred.

As part of the move to accrual accounting the ABS undertook a systematic review of its accounting policies including the definition and identification of the assets and liabilities which should be recognised in its financial statements. The treatment of the expenditure incurred in developing statistical systems was one of the areas reviewed. It was felt that as these statistical systems benefit the ABS for a number of years it was inappropriate to write them off in the year of expenditure. Accordingly these items, to the extent that their costs can be reliably measured, are now intended to be treated as assets and depreciate over their estimated useful lives. We believe that in time this would lead to an enhanced awareness of the

assets that are utilised or consumed, and the extent of such consumption, in providing services. This in turn would lead to a fuller appreciation of all the costs of the services we provide whether or not cash was expended in a particular year.

Commonwealth Scientific and Industrial Research Organisation

Overhead Attribution for Balancing Resource Allocation to Research Priorities

A Division operated several field stations to conduct agricultural field trials. The field stations were available to, and used by, a number of the research programs. The field stations were regarded as a Divisional overhead along with administration, workshops, library, etc.

The Division conducted a complex priority-setting exercise to determine its research priorities and to ensure they were consistent with industry priorities. Funds remaining after overhead activities were funded were allocated to research programs according to research priorities.

To better align resource allocation with research priorities, management decided to convert as many overhead costs to direct costs by distributing them to research programs where possible. At the time investigation revealed that only one research program was consistently using one of the field stations. Upon distribution of the research station costs to that program it was found that the total resources consumed by the program were much higher than its priority ranking warranted and that the field station was under utilised. As a result the field station was sold and facilities are now leased for field trials as the need arises. Ongoing savings are distributed according to the Division's priority-setting process.

Costs of Infrastructure Attributed Using an Internal Lease Scheme

CSIRO operates an "internal lease scheme". The scheme involves all occupiers of buildings being charged a lease fee based on long term commercial rental rates. Lease charges are included in management reports provided to research managers.

Research managers can reduce their lease payments by reducing their usage of facilities. They can reallocate any funds thus freed up for research.

The scheme provides a number of benefits:

- it ensures that adequate resources are available to maintain, refurbish and acquire facilities;
- it maintains a focus on the real costs of research and infrastructure;
- it encourages research managers to avoid the unnecessary use of infrastructure, thus maximising the funds available for the research effort; and
- it provides a basis for conducting economic appraisals of projects.



INTRODUCTION

Background to the Review

1.1 Pursuant to section 8(1)(ab) of the *Public Accounts Committee Act 1951*, the Committee examines all reports of the Auditor-General, including efficiency audit reports.

1.2 This report examines two recent reports of the Auditor-General dealing with the introduction of accrual reporting in agencies of the Commonwealth Government - *Audit Report No. 32, 1993-94, Efficiency Audit, Accrual Reporting - Are Agencies Ready?* and *Audit Report No. 16, 1994-95, Follow-up Audit, Accrual Reporting - Are Agencies Ready?* These reports examined the preparedness of agencies to meet the Government's deadline of producing accrual based financial statements for the year ended 30 June 1995.

1.3 The Committee has a longstanding interest in encouraging Commonwealth agencies to adopt accrual reporting practices. For example in *Report 34, The Trust Fund*, which was tabled in 1957, the Committee argued that Commonwealth bodies operating on a trust account, rather than from the Consolidated Revenue Fund, should keep a profit and loss account and a balance sheet which should be certified by the Auditor-General.¹

1.4 Later, in 1982, the Committee recommended that cash based accounting should be eliminated as the primary basis for financial reporting by Commonwealth authorities and, instead, that accrual accounting should be adopted.²

1 Joint Committee of Public Accounts, *Report 34, The Trust Fund*, Commonwealth Government Printer, Canberra, 1957, p. 39.

2 JCPA, *Report 199, The Form and Standard of Financial Statements for Commonwealth Undertakings - A Discussion Paper*, AGPS, Canberra, 1982.

1.5 The issue also arose on many occasions in evidence to the Committee's recent inquiry into the commercialisation of public sector operations.³ It is clear from evidence to that inquiry that many Commonwealth agencies, particularly those which have moved to adopt a more commercial approach to program and service delivery, have found accrual reporting and accounting to be valuable management tools.

1.6 In these circumstances, the Committee was keen to examine the Auditor-General's reports. In particular the Committee was interested in examining:

- the efficiency and effectiveness with which agencies were preparing their accrual reports;
- the use being made of accrual-based financial information both within agencies and elsewhere;
- the progress being made by agencies from accrual reporting to full accrual accounting; and
- the assistance being provided to agencies by the central co-ordinating agencies.

Key Concepts

1.7 This section describes some of the important terms and concepts which are discussed in this report.⁴

The Committee recommended that the statements should contain information about the resources available to the authority; its obligations; changes in resources and obligations; resource flows; liquidity; budget forecasts of operations; and commitments and contractual arrangements (Report 199, p. 46).

³ The Committee reported on this inquiry in April 1995, see JCPA, *Report 336, Public Business in the Business Interest: An Inquiry into Commercialisation in the Commonwealth Public Sector*, AGPS, Canberra, 1995.

⁴ The information in this section is summarised from two sources: Auditor-General, *Audit Report No. 32, 1993-94, Accrual Reporting - Are Agencies Ready?*, and, in particular, Exhibit No. 37, Department of Finance, *The New Financial Reports of Agencies - A Guide to the Use of Accrual Accounting and Reporting by Commonwealth Agencies*, July 1994.

Cash Accounting

1.8 Traditionally governments have operated on an annual cash basis. This reflects the fundamental principle, articulated in sections 81 and 83 of *The Constitution*, that no public monies shall be spent except in ways and in amounts specified in annual appropriations made by Parliament.

1.9 Cash accounting records cash receipts, payments and balances at the time cash is exchanged. Financial statements prepared using cash accounting:

- show the source of cash receipts;
- reveal how the cash has been allocated; and
- provide a comparison against budgeted amounts.

1.10 For internal management purposes, information about cash enables management to control and monitor receipts and payments against budget. When included in annual reports, cash based information allows management to account to Parliament for appropriated moneys.

Accrual Accounting

1.11 Accrual accounting recognises revenue and expenses in the accounting period in which they occur, irrespective of when cash is paid or received. It aims to match the costs incurred during a particular reporting period with the benefits earned in that period.

1.12 'Revenues' and 'expenses' under accrual accounting include items which are not usually covered in 'receipts' and 'payments' under cash accounting, such as:

- the cost of consuming assets - for example, depreciation;
- the cost of accruing employee entitlements such as long service leave; and
- the value of goods and services received free of charge from other bodies.⁵

1.13 Accrual information is a useful aid to management decisions about total resource allocation, and enables managers to discharge their accountability responsibilities for overall resource management.

1.14 It is important to note that cash accounting and accrual accounting are not alternative systems. Rather, cash accounting is a subset of the more comprehensive full accrual accounting system.

Accrual Reporting

1.15 Accrual reporting refers to the preparation, usually annually, of financial statements and reports based on accrual information. Accrual based financial statements contain more information than is typically disclosed under a cash based reporting system.

1.16 Accrual-based financial statements, comprise:

- an operating statement;
- a program statement;
- a statement of assets and liabilities;
- a statement of cash flows; and
- a statement of transactions by fund

together with additional notes, disclosures and the certificates of the Chief Executive and the Auditor-General.

1.17 These statements are designed to meet the needs of a wide range of external users, including members of Parliament.

Whole of Government Reporting

1.18 Whole of government reporting is a form of general purpose financial reporting where the financial statements of the various entities controlled by a government are consolidated to show the financial activities and performance of the government as a whole.

1.19 The preparation of whole of government reports on an accrual basis involves the aggregation of each agency's revenues, expenses, assets and liabilities, and the elimination of any

interagency transactions to avoid double counting.

1.20 Accrual based whole of government reports are typically presented as an integrated set of financial reports, structured along similar lines as those described in paragraph 1.15.

The Review Process

1.21 In conducting its review, the Committee sought submissions from:

- the Department of Finance (Finance), as the Commonwealth agency with responsibility for financial administration and accounting policy;
- from the agencies referred to in the audit report;
- from Auditor-General, Treasuries and Finance Departments in the States and Territories;
- from individuals and organisations with a professional interest in accounting matters; and
- from the Australian National Audit Office (ANAO).

1.22 The Committee also received information from the New Zealand High Commission about the New Zealand Government's systems of financial management and reporting.

1.23 A list of submissions and exhibits can be found at Appendices I and II.

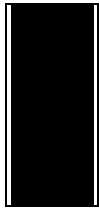
1.24 The Committee also took evidence at a number of public hearings and held discussions with the Auditor-General and representatives from the accounting firm Coopers & Lybrand. A list of the public hearings and the witnesses who gave evidence at the hearings is at Appendix III.

The Structure of the Report

1.25 This report continues with a discussion of accrual reporting in the Commonwealth context and proceeds, in Chapter 3, with a consideration of the issues arising from the two audit reports.

1.26 Chapter 4 discusses the uses to which the information in accrual reports can be put and is followed, in Chapter 5, by a

discussion of the way in which accrual information can be used by managers as an aid to day to day decision making. Chapter 6 considers the steps which could be taken to encourage agencies to introduce full accrual accounting for management purposes and the Report concludes, in Chapter 7, with a discussion of the next major accounting reform for the Commonwealth - whole of government reporting.



ACCRUAL REPORTING - THE COMMONWEALTH CONTEXT

Financial Management Reform

2.1 A decade ago the Commonwealth Government embarked on a series of major reforms to increase the efficiency, effectiveness, responsiveness and accountability of the Australian Public Service (the APS).

2.2 The reform agenda was given definition with the publication of two white papers in the early 1980s: *Reforming the Australian Public Service* (1983); and *Budget Reform* (1984).

2.3 These papers proposed a centrally coordinated program of on-going improvement for public sector agencies. This program, which became known as the Financial Management Improvement Program (FMIP), has been an umbrella under which a broad range of reform initiatives have been developed and sponsored. The focus of FMIP reforms has been to:

- permit more strategic ministerial oversight and financial management of the impact of government programs;
- encourage contestability or market competition to influence the way in which goods and services are provided; and
- allow managers greater flexibility in deploying resources at the same time as requiring greater accountability for outcomes in program delivery.¹

1 Exhibit No. 37, p. 3.

2.4 Initiatives such as devolution of responsibility, the running costs arrangements, program management and budgeting, user charging, contracting out and corporate planning all fall within the broad framework of the reform process.²

2.5 Accrual reporting can be characterised as being one element of the various commercial reforms which have been introduced into the APS.

Accrual Reporting in the Reform Context

2.6 The introduction of accrual reporting and accounting was not a fundamental objective of the reform process. Indeed up until 1990 Finance had stated that there were no immediate plans to introduce accrual accounting methods to Commonwealth departments.³

2.7 The common wisdom at the time was that traditional cash-based forms of public sector financial reporting were appropriate and sufficient for budget sector agencies. The major reason for this belief was that such reporting reflects the cash-based nature of parliamentary appropriations and represents a sound means of ensuring that public monies are spent in the manner approved by Parliament.

2 Some of the particular aspects of the reform process have been listed by the Management Advisory Board (MAB) in 'An Illustrative Framework of the APS Reforms' which was published in, Task Force on Management Improvement, *The Australian Public Service Reformed: An Evaluation of a Decade of Management Reform*, 1992. This framework is reproduced at Appendix IV.

3 *The Australian Public Service Reformed*, p. 313.

2.8 However, the combined impact of measures to introduce commercial disciplines, to allow management flexibility and to institute new accountability standards pointed to the need for more comprehensive, and timely, information about financial performance. Information about resource use was needed not only to satisfy annual reporting requirements, but also as an aid to management decisions on a day to day basis. Information was needed to help managers make decisions about:

- *pricing of goods and services for cost recovery;*
- *cost control;*
- *liability containment;*
- *effective deployment of assets;*
- *controlling levels of capital receivable and inventories which may restrict cash flow;*
- *evaluating contracting out and leasing options; and*
- *workplace bargaining.*⁴

2.9 Many Commonwealth entities, particularly those charging for their services, have found that these needs have been met with the adoption of accrual accounting practices.

2.10 Accrual information has enabled managers to:

- identify the assets controlled by the agency and evaluate decisions concerning resource allocation and management;
- reveal the extent of the liabilities of an agency;
- make more informed judgements about program and agency performance; and
- account more comprehensively to Parliament for the use of appropriated moneys.

2.11 In summary, the availability of accrual information has enabled managers to consider the *full* cost of their operations when assessing performance and making decisions about future resource allocation.

The Extent of Accrual Reporting in the Commonwealth

4 *The Australian Public Service Reformed*, p. 318.

2.12 The process of moving Commonwealth agencies from traditional cash-based accounting systems to the more commercial accrual-based systems has, by design, been steady and measured.

2.13 Since 1983 all Commonwealth companies, statutory authorities and commercial activities within departments have been required, by corporations law or guidelines issued by the Minister for Finance, to produce financial statements on a full accrual basis.

2.14 The decision to require Commonwealth departments to produce annual financial statements on an accrual basis was announced by the then Minister for Finance, the Hon Ralph Willis MP, on 4 November 1992.

2.15 In making the announcement the Minister said that:

*... the proposed new reporting arrangements built on a series of reforms introduced by the Government over the past 10 years aimed at improving the efficiency and effectiveness of the public sector, and its accountability to the Parliament.*⁵

2.16 The implementation date was set for the year ending 30 June 1995. Ten departments elected to participate in a pilot program co-ordinated by Finance and prepared accrual-based statements for 1992-93. A further ten departments moved to the accrual format for 1993-94, leaving the rest, about 30 agencies, to report for the first time in 1994-95.⁶

5 Minister for Finance, *Media Release, Government to Move to Accrual Accounting*, 4 November 1992.

6 Finance, *Submission*, p. S1263.

New Financial Management Legislation

2.17 The financial management reforms to date have built upon the legislative framework described in the *Audit Act 1901* and, although the Audit Act has proved to have a remarkably robust structure, it is widely perceived that the Act is in need of modernisation.

2.18 To this end the Government has introduced a package of three Bills to replace the Audit Act. One of these Bills, the Financial Management and Accountability Bill 1994 (the FMA Bill), is intended to provide an accounting and reporting framework for the proper management of public money and public property. The legislation also proposes a system of rules about how public money and property are to be dealt with. One such set of rules - to be issued as Finance Ministers Orders pursuant to the legislation - are those which described the guidelines for preparing annual financial statements.

2.19 Two other provisions of the FMA Bill which are relevant to the issues before the Committee are those which:

- require Chief Executives to manage their agencies in a way that promotes the 'efficient, effective and ethical use' of Commonwealth resources (see Clause 45 of the Bill); and
- require Chief Executives to provide, at the request of the Minister for Finance, financial statements at any time during a financial year (see Clause 51 of the Bill).

2.20 The Committee has given detailed consideration to the FMA Bill, and the other elements of the package of legislation to replace the Audit Act, in its *Report 331*.⁷ The legislation is currently before the Senate.

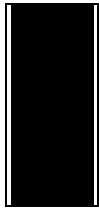
Audit Reviews

2.21 It was against this background that the Auditor-General decided it was appropriate and timely to undertake an efficiency audit of the accounting skills in the Commonwealth Budget sector to determine its ability to fulfil its existing and future accounting obligations.⁸

2.22 The results of the audit review are the subject of the next chapter.

7 JCPA, *Report 331, An Advisory Report on the Financial Management and Accountability Bill 1994, the Commonwealth Authorities and Companies Bill 1994 and the Auditor-General Bill 1994, and on a Proposal to Establish an Audit Committee of Parliament*, AGPS, Canberra, September 1994.

8 Auditor-General, *Audit Report No. 32, 1993-94*, p. 4.



ACCRUAL REPORTING - ARE AGENCIES READY?

The Auditor-General's Reports

The Audit Objective

3.1 The Auditor-General's objective in conducting the audit was to gauge whether budget sector agencies were well prepared to fulfil the then emerging requirements of accrual reporting.¹ Specifically, the audit aimed to:

- identify relevant accounting and financial management tasks and related skill needs;
- measure the distribution and adequacy of existing skills against these needs;
- identify skill gaps, both overall and in particular areas; and
- ascertain how such gaps might best be filled - for example, by recruitment, professional development or other means.²

The Findings of Audit Report No. 32, 1993-94

3.2 The overall finding of *Audit Report No. 32*, which was tabled in Parliament in March 1994, was that while most agencies saw benefit in moving to accrual accounting, many had not been well prepared for the accounting reforms introduced to date and were not well prepared for the introduction of full accrual reporting. The Auditor-General considered that if agencies were to produce accrual reports for the year ended June 1995:

1 The audit report defined the Commonwealth's 'budget sector' as being 'those departments and agencies which were required to report in accordance with the February 1992 version of the Financial Statement Guidelines for Departmental Secretaries'. See Auditor-General, *Audit Report No. 32, 1993-94*, p. 5.

2 Auditor-General, *Audit Report No. 32, 1993-94*, p. 4.

- they needed to quickly address the organisational and staffing requirements flowing from management reforms in general and the move to accrual reporting in particular;
- they needed to adapt and integrate systems to meet the reporting requirements; and
- they may need to use consultants or contractors to assist in the transition to accrual reporting.³

3.3 *Audit Report No. 32, 1993-94*, contained 11 recommendations, some directed to Finance and the Public Service Commission (PSC) as the relevant coordinating agencies, and some directed to agencies in general as a checklist of items to help agencies prepare for accrual reporting. The key elements of the audit recommendations were that:

- individual agencies and Finance should take action to improve the level of awareness and understanding amongst staff of the benefits of the financial reporting reforms;
- individual agencies, Finance and PSC should take action to identify the type of accounting skills required to effectively implement the reporting reforms, to match staff skill levels to job skill requirements, to provide appropriate training;
- individual agencies should take appropriate recruitment action; and
- individual agencies should implement accounting and financial management information systems suitable for accrual reporting.⁴

The Findings of the Follow-up Audit

3.4 The report of the follow-up audit, *Audit Report No. 16, 1994-95*, which was tabled in December 1994, contains an assessment of the action taken by agencies to address audit's original concerns. The Auditor-General found that:

3 Auditor-General, *Audit Report No. 32, 1993-94*, p. xvii.

4 Auditor-General, *Audit Report No. 16, 1994-95*, pp. 4-5.

- all agencies surveyed had taken action to improve the level of staff awareness and understanding of accrual reporting requirements;
- although progress had been slow in identifying job requirements and staff skills, action had been taken in the majority of agencies to identify training needs and provide training;
- agencies had successfully recruited specialist accounting staff; and
- agencies had made appropriate use of consultants during the transition period.⁵

3.5 In a subsequent submission to the Committee, ANAO concluded that since the original audit 'progress in the agencies surveyed appeared to be satisfactory, although uneven'.⁶

3.6 In relation to the assistance provided by Finance, the Auditor-General commented that whilst reporting that 'agencies were satisfied with the overall level of assistance', there was 'a need for further improvement in the quality and timeliness of assistance' in certain areas.⁷ Accordingly, *Audit Report No. 16, 1994-95* contained recommendations that:

*... DoF continue to identify, promote and disseminate to all budget sector agencies best practice on issues relating to the implementation of accrual concepts. ... [and] ... complete its consultations with agencies in order to identify those agencies that might require additional assistance with the preparation of accrual reports for 1994-95.*⁸

5 Auditor-General, *Audit Report No. 16, 1994-95*, pp. 12-3, 16-7, 21-2, 23 and 26.

6 ANAO, *Submission*, p. S1647.

7 Auditor-General, *Audit Report No. 16, 1994-95*, p. vii.

8 Auditor-General, *Audit Report No. 16, 1994-95*, Recommendations 2 and 5, pp. xii-xiii.

The Ernst & Young Survey

3.7 In February 1995 the accounting firm Ernst & Young released the results of a national survey of accrual accounting in the public sector. The survey was commissioned in mid-1994,⁹ and was set against the issue of Australian Accounting Standards AAS27 and AAS29 which called for the adoption of accrual reporting at Local, State and Commonwealth government levels.¹⁰ The purpose of the survey was to assess progress toward the integration of accrual concepts into financial management structures; and to identify the costs and benefits that agencies had identified to date.

3.8 Some 450 individuals with direct financial and/or accounting responsibilities were surveyed across all levels of government in all jurisdictions, including government business enterprises. The survey presented the results of 255 responses and addressed:

- progress in the practical implementation of accrual accounting;
- how well the perceived benefits of accrual accounting are being realised; and
- the nature of obstacles to effective implementation.¹¹

3.9 The results of the survey, although largely dealing with the introduction of accrual accounting, noted in relation to the preparation of accrual reports that:

- some 30 per cent of agencies had not used an implementation plan;

9 Geoffrey Applebee, Partner, Ernst & Young, *Transcript*, p. 64 (Canberra, 13 February 1995).

10 Australian Accounting Standard 27 - Financial Reporting by Local Governments (AAS 27) and Australian Accounting Standard 29 - Financial Reporting by Government Departments (AAS 29).

11 Exhibit No. 6, Ernst & Young, *Accrual Accounting in the Public Sector: A National Survey*, p. 1.

- the most significant problems in preparing reports related to developing revised information systems, establishing accounting policy directions and preparing procedure manuals; and
- over 30 per cent of respondents saw no other use for accrual reports than to satisfy a legislative reporting requirement.¹²

The Issues Which Remain to be Addressed

Introduction

3.10 The work done by ANAO and Finance has been instrumental in helping individual agencies prepare themselves for the implementation of accrual reporting. Both have helped focus attention on the issues to be addressed and have provided advice and guidance to other agencies.

3.11 The Committee understands that all agencies will be in a position to include accrual based financial statements in their annual reports for 1994-95. These annual reports are required to be tabled in Parliament by 31 October 1995.

3.12 The presentation of accrual reports will be a major milestone in the public sector reform process. However, it is not the end of the reform process. As the then Acting Auditor-General, Bill Nelson, said in evidence to the Committee, the production of accrual reports in 1994-95 is only 'the first phase of the use of accrual concepts'.¹³ The next phase involves more work on matters such as:

- improving the efficiency of the reporting process;
- explaining more widely the uses to which accrual information can be put;
- encouraging agencies to move to full accrual accounting; and

12 Exhibit No. 6, p. 2.

13 Bill Nelson, Acting Auditor-General, *Transcript*, p. 6 (Canberra, 13 February 1995).

- assessing the value of further financial reporting reforms, such as whole of government reporting.

Efficient Accrual Reporting

3.13 The ANAO has advised the Committee that although all agencies will present accrual based financial statements on time, there are reasons to be concerned about the efficiency of the processes employed to produce the statements.

... most agencies use cash-based systems throughout the year and rely on a process of end-of-year adjustments to produce accrual-based reports. In large agencies the number of required end-of-year adjustments alone may be cause for concern in relation to efficiency.¹⁴

3.14 The ANAO also noted that the financial statements of many of the agencies involved in the accrual reporting pilot program required:

... a significant number of amendments ... as well as a great deal of assistance ... [from] ANAO staff, to enable unqualified audit reports to be issued ... [this] was indicative of the potential for improvement.¹⁵

3.15 Most of the difficulties facing agencies can be attributed to one or more of the following issues:

- the ability of management information systems to provide accrual information;
- the need to set accounting policies, particularly asset valuation policies; and
- the need to conduct skills audits, provide appropriate training and take appropriate recruitment action.

14 ANAO, *Submission*, p. S1648.

15 ANAO, *Submission*, pp. S1648-9.

3.16 Such difficulties are not surprising given the magnitude of the changes required. It is evident that agencies are adapting to the new reporting requirements and, although both ANAO and Ernst & Young have suggested that progress is uneven and slow, further improvements can be expected as agencies settle into the accrual reporting process. For example, in future years less time will need to be devoted to setting accounting policies; staff will become increasingly familiar with the new procedures; and information systems problems will be addressed.

3.17 On the issue of recruiting staff with the necessary experience and skill, the Committee was interested to learn of the steps taken by a number of Commonwealth and State agencies to recruit accountants with commercial experience. Recruits with this type of background may bring to the public sector a practical understanding of how accrual accounting systems work and how they can be established. Such people, employed on either a full time basis or as part time members of internal audit committees or implementation teams, can provide valuable advice to agencies grappling with the reform.¹⁶

3.18 Nevertheless, the Committee is concerned that some of these difficulties, and probably the most intractable of them, will not be resolved properly until the Government expresses a clear vision of where the reform process is heading.

3.19 The goal set by the Minister for Finance in 1992 that accrual reports be presented for 1994-95, is on track to be achieved, but there is no explicit statement of direction to guide agencies beyond accrual reporting.

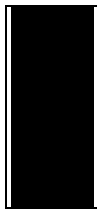
3.20 Agencies have responded to the imperative of producing accrual reports and have taken such training, systems and policy development steps as have been necessary to meet the target. There is a danger, however, that future progress will be limited by uncertainty within agencies about the relevance of accrual concepts, or about the priority to attach to further systems and policy development work.

16 See Frank King, Deputy Secretary, Victorian Department of the Treasury and Finance, *Transcript*, p. 176 (Melbourne, 10 April 1995).

3.21 The efficiency of the reporting process is intrinsically bound up in the question of where to from here. Until a clear and unambiguous direction is set, the incentives to make the process more efficient are limited and many managers will continue to regard accrual reporting as a requirement of little relevance to their day to day work.

3.22 In the chapters that follow the Committee considers some of the issues which may help to focus attention on the steps beyond accrual reporting, they are:

- the value of accrual information;
- the value of full accrual accounting; and
- the value of whole of government reporting.



USING ACCRUAL REPORTS

Introduction

4.1 If the impact of accrual reporting is to be maximised, steps must be taken to educate people about the use that can be made of the information contained in accrual based financial statements.

4.2 The training which has been undertaken to date has, in the main, focussed on the needs of those involved in preparing financial statements. This focus is quite appropriate and the need for such training will continue for some time yet. However, the next step is to consider the needs of those who may use financial statements.

4.3 This chapter draws on material contained in the Finance publication *The New Financial Reports of Agencies*, and on evidence presented during the Committee's review, to describe some of the uses which can be made of information derived from accrual reports. The chapter concludes with a number of suggestions about steps which could be taken to educate people in the use of accrual information.

Who Uses Financial Statements?

4.4 The annual financial statements of Commonwealth departments are prepared pursuant to section 50 of the Audit Act and in accordance with guidelines from time to time issued by the Minister for Finance. The current financial statements guidelines were issued in March 1995 and reflect AAS 29. It is this Standard which calls on government departments to prepare accrual based reports.

4.5 The financial statements required by these guidelines are known as 'general purpose financial reports' and are

concerned with providing information to meet the common information needs of external users who rely on information communicated to them by a department in published financial statements.

4.6 AAS 29 requires departments to produce general purpose financial reports which are:

... useful to users for making and evaluating decisions about the allocation of scarce resources and which assist government departments to discharge their accountability obligations.¹

4.7 The main users of the general purpose financial statements are described in AAS 29 as being:

- the Parliament;
- those providing the resources that departments control (for example, taxpayers and creditors);
- those receiving goods and services or otherwise benefiting from the department's activities (for example, consumers and debtors); and
- those performing oversight or review services on behalf of the community (for example, regulators, community groups and the media).²

4.8 The Standard goes on to note that many users are unable to command the disclosure of the financial information they require and hence are dependent on the general purpose financial reports prepared by departments to satisfy their information needs.³

1 AAS 29, Preface.

2 AAS 29, section 21.

3 AAS 29, section 21.

4.9 In *The New Financial Reports of Agencies*, Finance makes the point that accrual reports will contain information useful to all users.

While the main focus will be on performance in managing resources, the reports will continue to provide accountability for the proper use of public moneys.⁴

What do Accrual Statements Look Like?

4.10 As outlined in Chapter 1, the new financial statements of departments will comprise:

- an operating statement;
- a statement of assets and liabilities;
- a program statement;
- a statement of cash flows; and
- a statement of transactions by fund

together with additional notes, disclosures and the certificates of the Chief Executive and the Auditor-General.

4.11 The *Operating Statement* focuses on the net cost of services provided by the agency and the revenues received from both government and independent sources. Revenues and expenses administered for the Commonwealth (such as taxes and social security payments), appear in a separate part of the statement. This statement enables assessments of: resources obtained or used on behalf of the government; the cost of administering them; and changes in administrative efficiency. Users will be able to compare the amount and composition of resources used and recovered with corresponding amounts for the previous year and with other agencies for benchmarking purposes.⁵

4 Exhibit No. 37, p. 43.

5 Exhibit No. 37, pp. 13-4.

4.12 The *Program Statement* disaggregates the information in the Operating Statement into programs, and shows assets and liabilities attributable to each program. This statement makes it easier to match costs and revenues with outputs. If agencies attribute corporate overheads to primary programs, the full program costs can also be obtained.⁶

4.13 The *Statement of Assets and Liabilities* is similar to the balance sheet of a company. The statement includes the major categories of assets and liabilities controlled by the agency and indicates which categories are current (held for up to 12 months) and which are non-current (held for more than 12 months). Assets and liabilities administered for the Commonwealth as a whole are highlighted in a separate part of the statement. The Statement of Assets and Liabilities will enable users to assess how resources and obligations have been managed and therefore assist management to discharge their accountability.⁷

4.14 The *Statement of Cash Flows* indicates the sources of cash inflows and how cash was applied by agencies during the financial year and for the previous year. The statement classifies cash flows according to whether they relate to operating, investing or financing activities. Any transactions administered for the Commonwealth as a whole are shown separately from agency transactions.⁸

4.15 The *Statement of Transactions by Fund* shows an agency's receipts and payments against budget estimates for each statutory fund. The Statement's major objective is to provide accountability for the expenditure of public monies appropriated by Parliament.⁹

6 Exhibit No. 37, pp. 14-5.

7 Exhibit No. 37, pp. 15-6.

8 Exhibit No. 37, p. 16.

9 Exhibit No. 37, p. 16.

How Can Accrual Reports Be Used?

Introduction

4.16 The new accrual based statements are designed to facilitate more effective scrutiny of agency performance and enable questioning of such matters as the efficiency of administration and deployment of assets.

4.17 The statements will contain a wealth of information which can be used to construct a range of specific performance indicators to monitor and assess the performance of agencies and programs within agencies. The information can also be used in a predictive sense to help decision makers assess the impact of proposed resource allocations on other programs within an agency or on the whole agency.

4.18 It is important to recognise that a number of the measures of financial position and performance in the private sector are either less relevant or meaningless in the public sector. For example, private sector entities are required to disclose, in their financial statements, information on the entity's financial performance; control over resources; financial structure; capacity for adaptation; and solvency. These concepts are less relevant to core public sector agencies because:

- in the private sector, performance is concerned with profitability - profit is neither an objective nor a performance measure for the core public sector, its aim being to deliver goods and services in accordance with government policy;
- information about resources in the private sector is used to predict the entity's ability to continue operating - in the public sector information about assets and liabilities provides accountability for use of public monies and management of those resources;
- financial structure information in the private sector is important in attracting resources from creditors, financial institutions, and investors - in the public sector an agency's viability is determined by the Government and will of Parliament;
- capacity for adaptation, ie the ability for an entity to modify its composition of resources, remains relevant for asset management. Additional information may be required, for example, on any restrictions imposed on

- an agency regarding asset use; and
- information in the private sector on solvency is relevant in predicting an entity's ability to meet its financial commitments as they fall due - this information is not relevant to budget dependent bodies as their solvency is determined by the will of Parliament rather than their capacity to earn net returns.

4.19 It is possible, however, to derive alternative measures of financial performance and position for use in the public sector. Some of these indicators are described below.

Comparisons, Benchmarks and Trends

4.20 The information contained in accrual-based financial reports is presented in such a way as to facilitate comparisons between reporting periods and between different entities. This means it is comparatively easy to establish trends and identify performance benchmarks.

4.21 Indeed, short-term trends will be revealed in the statements themselves, which will contain information about the current and immediately preceding reporting periods.

4.22 Performance benchmarks can be established by comparing equivalent items between similar entities.

4.23 Perhaps the most powerful aid in assessing agency or program performance will be to compare ratios of financial performance, financial position and cash flows. A comparison of such ratios over time could be an important way of highlighting best practice or trends and calling agencies to account for departures from these marks.¹⁰

4.24 The following sections discuss these three types of ratios.¹¹

10 Exhibit No. 37, pp. 45-6.

11 A full list of the financial performance, financial position and cash flow ratios which can be derived from accrual based financial statements and used as performance indicators is at Appendix V.

Assessing Financial Performance

4.25 Performance, as an accounting term, is defined as the proficiency of an entity in acquiring resources economically and using them efficiently and effectively in achieving specified objectives. In the context of budget-dependent bodies, any assessment of financial performance needs to focus on costs, physical outputs and changes in efficiency (that is, the extent to which an agency maximises outputs for a given set of inputs and minimises input costs for a given level and quality of outputs).¹²

4.26 Because accrual based statements recognise the full cost of agency activities, it is possible to quantify the input costs of program delivery, thereby determining the cost of goods and services provided. This information can then be related to information about physical program output, (such as tax returns assessed or benefits payments made). Unit cost can then be calculated and comparisons made with previous reporting periods or other benchmarks.

4.27 Performance indicator ratios can be devised which show, for example:

- **employee support costs** - that is, the annual administration cost for each employee (for example, rent, power and depreciation of plant and equipment);
- **self-sufficiency** - that is, the reduction in budget dependency resulting from user charges and asset sales; and

- **benefits administration costs** - that is, the net annual administration cost for each benefit payment (for example, payments for Austudy, unemployment benefit, etc.)¹³

Assessing Financial Position

4.28 As discussed earlier, many of the typical measures of financial position (such as solvency, control over resources and financial structures) are designed for commercial entities and are not relevant to core activities of government.

4.29 Nevertheless, some measures of financial position can be devised and used to assess an agency's management of assets and liabilities. The following indicators could, for example, be used:

- **trade debtors**, which shows the average number of days that trade debtors are outstanding during the year;
- **days inventories held**, which shows the average number of days that inventories are held prior to sale or use;
- **program receivables**, which shows the average number of days that program receivables are outstanding during the year (for example, tax receivables);
- **employee entitlements**, which shows the average liability for employee benefits per employee at the end of the financial period; and

13 The financial performance ratios are calculated in the following manner:

- employee support costs, by dividing costs such as rent, electricity and depreciation, by the average number of employees;
- self-sufficiency, by dividing (revenues from independent sources x 100) by total operating expenses; and
- benefits administration costs, by dividing the net cost of services by the number of benefit payments, (Exhibit No. 37, p. 49).

- **change in composition**, which highlights changes in the composition of assets and liabilities that may warrant further inquiry.¹⁴

Assessing Cash Flows

4.30 Under accrual accounting, managers still require cash information in order to monitor their cash management and to account to Parliament for their annual appropriations.

4.31 A number of cash flow ratios can be used to make detailed assessments of the way an agency has used its cash during a financial year, for example:

- **funding of services**, which shows the extent to which cash is provided for net agency costs;
- **reinvestment**, which shows the proportion of net cash from operations reinvested in assets;
- **depreciation impact**, which shows the proportion of net cash from operations that may need to be reinvested in assets over time; and
- **reinvestment sufficiency** which shows the sufficiency of reinvestment and maintenance of asset base.¹⁵

14 The financial position ratios are calculated in the following manner:

- . trade debtors, by dividing (average trade debtors x 365) by total credit sales;
- . days inventories, by dividing (average inventories x 365) by inventories sold or used;
- . program receivables, by dividing (average program receivables x 365) by program revenues;
- . employee entitlements, by dividing the employee benefits payable by the number of employees; and
- . change in composition, by the change in the percentage of the item to the total (Exhibit No. 37, p. 53).

15 The cash flow ratios are calculated in the following manner:

- . funding of services, by dividing the cash provided by Government by the net cost of services;
- . reinvestment, by dividing purchases of assets by net cash from operations;
- . depreciation impact, by dividing depreciation by the net cash from oper-

Conclusions

General

4.32 In the Committee's opinion much value can be derived from the information contained in accrual-based financial statements. Clearly, the extent to which this value is realised depends significantly on the level of understanding that users have of accrual reports. It seems at present that the level of understanding among all categories of users, internal as well as external, is limited.

4.33 In these early stages of accrual reporting it is incumbent upon all involved in the process to do as much as possible to educate those who use, or may come to use, accrual reports.

4.34 The Committee is aware that Finance, a number of the major accounting firms and the Australian Society of Certified Practising Accountants have developed training courses for officials involved in the move from cash to accrual reporting. In May 1995, for example, Finance released a new 'suite' of training courses comprising four modules, three of which focus on the information needs of those involved in preparing accrual reports.¹⁶

4.35 Finance has also published *The New Financial Reports of Agencies*, which describes many of the features of and uses which can be made of accrual based financial statements. In addition, a number of agencies have prepared information brochures and manuals to help their staff in the transition. These initiatives have been valuable and undoubtedly have been of great assistance to those involved in preparing accrual reports.

4.36 Such work should continue, but with an expanded focus to include those who use accrual reports. This target group includes senior managers within Government, parliamentarians and those working with parliamentarians, private sector

ations; and

. . . reinvestment sufficiency, by dividing the reinvestment ratio by the depreciation impact ratio (Exhibit No. 37, p. 55).

16 Exhibit No. 49, Finance, *Suite of Accrual Training Courses*.

economic and policy analysts and journalists.¹⁷ A marketing strategy, which focuses on more than just training and includes promotional elements, should be developed to help spread the message about the usefulness of accrual reports. The following recommendations are directed to this end.

4.37 **Recommendation 1**

The Department of Finance should:

- (a) develop a professional marketing strategy directed at potential users of agency financial statements and with the aim of promoting the use which can be made of the accrual based information contained in financial statements;*
- (b) as part of the marketing strategy, distribute its publication The New Financial Reports of Agencies widely within the target group of people who may use agency financial statements, including - Ministers and their staff, parliamentarians and their staff, senior public service managers, internal auditors and program evaluators, peak industry and community groups, industry regulators, key economic and policy analysts, and the media;*
- (c) as part of the marketing strategy, prepare and distribute widely information/promotional brochures containing extracts from The New Financial Reports of Agencies and examples of how accrual information can and has been used; and*
- (d) coordinate these activities with the tabling in Parliament of the 1994-95 annual reports of Commonwealth agencies.*

17 In the period 1 May 1995 to 20 July 1995, Finance provided 57 training courses on accrual matters - seven of which were directed at users of accrual information. The focus of courses run by the Society of Certified Practising Accountants and Coopers & Lybrand has similarly been on preparers rather than users - nine courses have been run with three aimed at users (see, Finance, *Submission*, p. S1999).

4.38 **Recommendation 2**

The Departments of the Senate and the House of Representatives, in conjunction with the Department of Finance, should develop information and training packages on the new financial reports of agencies for parliamentarians and parliamentary staff.

4.39 In addition, the Committee proposes to write to all Parliamentarians and party whips informing them of the introduction of accrual reporting and pointing out the type of accountability and performance information that can be derived from such reports.

Specific benefits

4.40 As described earlier, one significant advantage to be drawn from accrual information is the ability to make comparisons between reporting periods and between agencies.

4.41 In *The New Financial Reports of Agencies*, Finance encourages users to calculate comparative ratios of financial performance, financial position and cash flows and to:

- *seek explanations (e.g. in the notes) for significant changes between years;*
- *benchmark common ratios against other agencies; and*
- *where overhead expenses are allocated to programs, apply ratios at program level as well as for the agency as a whole.¹⁸*

4.42 Finance has also encouraged agencies to acknowledge the value of such information and to assist users by including in their financial statement:

... a range of charts and tables derived from the statements. These, in turn, can be supported by brief explanatory notes.¹⁹

4.43 The Committee was interested to learn that Finance proposes to collect and analyse this type of comparative

18 Exhibit No. 37, p. 46.

19 Exhibit No. 37, p. 46.

information because of its value in revealing 'key areas which might need to be looked at'.²⁰

4.44 An example of the type of comparative information which can be generated is the following chart, which shows an inter-agency comparison of employee support costs.

4.45 The chart was supplied by Finance and has been calculated from audited financial statements published by departments participating in the accrual reporting pilot program. In this program 26 agencies trialled the preparation of accrual reports for 1993/94.

4.46 Finance has advised that the figures for four departments are not comparable because they operate trust account businesses, hence they do not appear in the chart. Also, some departments may vary in their recognition of part time and temporary employees. It is anticipated that for 1994-95, departments with trust account businesses will be presented separately and that any inconsistencies in the data will be eliminated.

4.47 The value of the information which can be derived from accrual reports by calculating performance ratios and by making comparisons over time or between agencies is particularly apparent when presented in a table or chart as above. The value of information, for both internal management and external review purposes, is diminished if it is presented as raw data alone.

4.48 In the Committee's view agencies should include, as attachments to their annual financial statements, a selection of charts and tables, based on key performance ratios, highlighting the most significant information contained in the statements. The value of this type of information would be enhanced if agencies published comparable data in a time series, perhaps showing performance over a four or five year period, to reveal trends in their performance.

4.49 This suggestion is consistent with the increasing

emphasis being placed on performance reporting in the annual report requirements for departments and authorities.²¹

4.50 A further and, in the Committee's opinion, highly desirable development would be for Finance to collect, analyse and table in Parliament, on an annual basis, a consolidated series of charts and tables comparing the performance of all Commonwealth agencies against a range of key performance ratios.

4.51 Such reports would act as significant incentives toward improvements in management performance.

4.52 **Recommendation 3**

The Department of Finance should:

- (a) *amend the Financial Statement Guidelines for Departmental Secretaries and the Financial Statements of Commonwealth Authorities to require Chief Executives to include in their financial statements a range of tables and charts, based on key performance ratios, highlighting significant information contained in the statements;*
- (b) *prepare, for the guidance of agencies, a number of sample charts and tables based on key performance ratios; and*
- (c) *collect, analyse and table in Parliament on an annual basis a consolidated series of charts and tables comparing the performance of all Commonwealth agencies against a range of key performance ratios.*

21 See the *Annual Report Requirements for Departments* approved by the JCPA in March 1994 and the Exposure Draft on *Report of Operations* for Commonwealth authorities issued in June 1995.



THE MOVE TO FULL ACCRUAL ACCOUNTING

Introduction

5.1 Although accrual reports are potentially very useful, the value of accrual information for managers is fully realised only when the information contained in accrual reports is available to support day to day management decisions.

5.2 This point was stressed by ANAO in their submission:

One of the major aims of the introduction of accrual reporting was to assist agency management to utilise their agency's resources more efficiently and effectively. The ANAO strongly believes that the significant benefits to be gained in terms of improved management, resource savings and program outcomes will only be fully realised when accrual accounting is used as an everyday management tool.¹

5.3 Unless accrual information is available and used in decision making, the financial reform process will have been little more than an interesting, and expensive, accounting exercise.

5.4 To realise this potential, managers need to have accrual information available on a regular basis throughout a reporting period. In effect, this means that agencies need to implement financial management systems which provide reports on an accrual basis.

5.5 To date, only a handful of agencies have implemented accrual accounting systems and are using accrual information as a management tool - the Australian Bureau of Statistics (ABS) has a well developed accrual system and other agencies, including the Commonwealth Scientific and Industrial Research Organisation (CSIRO), the Department of Administrative Services, the Attorney-General's Department and the Australian Broadcasting Corporation, have incorporated accrual elements into their systems. The Department of Employment, Education and Training is moving toward accrual accounting with an implementation target of 1996-97.

5.6 This chapter describes some of the advantages which an agency can derive from the introduction of full accrual accounting and considers the argument, which still has some currency within sections of the APS, that accrual accounting is not appropriate for all areas of the public sector.

Accrual Accounting as a Management Tool

Introduction

5.7 As noted earlier, the introduction of accrual accounting is not an end in itself. Accrual accounts do not do anything of their own accord. The value is in the opportunities that accrual information presents and ultimately in the use that is made of the information.

5.8 From a management perspective, the regular provision and use of accrual information can result in:

- more effective asset and liability management;
- better assessments about the true and full cost of outputs; and
- opportunities for performance improvement.

Management of Assets

5.9 A widely acknowledged benefit of the accrual method is its potential to provide for improved asset management. If managers know the value of the assets they control, and the uses to which they are put, they are better able to make informed decisions on such issues as:

- whether assets are being fully utilised;
- whether assets should be retained or sold; and
- whether current levels of provision for asset maintenance are appropriate.

5.10 Mr Russell Walker, the Assistant Auditor-General for Victoria, argued in evidence to the Committee that, unless governments have available quality information about public assets and their use, there is a risk that the government's asset base will be run down or underutilised or otherwise mismanaged.² He stated that regular reporting, in an accrual context, of an agency's assets could prompt informed decisions concerning their use.

There may be billions of dollars worth of taxpayers' funds tied up in art collections. Someone has got to make an informed decision on what level of taxpayers' funds should be tied up in art collections. ... If we have a value, the taxpayer might say, 'I want only \$3 billion worth of funds tied up in art collections. I want the rest to deviate over to another program.' If you do not have that information, you cannot make an informed decision.³

5.11 A case study of how accrual information can lead to better asset management was provided to the Committee by CSIRO. The organisation decided that, in an attempt to better manage its overhead costs, it would allocate those costs to programs wherever possible. The exercise revealed that a particular asset was only being consistently used by one program and, consequently its costs were allocated to that program. The result was that the total resources consumed by that program

2 Russell Walker, Assistant Auditor-General for Victoria, *Transcript*, p. 183 (Melbourne, 10 April 1995).

3 Russell Walker, *Transcript*, p. 190 (Melbourne, 10 April 1995).

were much higher than warranted by its priority within the organisation, and that the asset in question was being under-utilised. This prompted a decision to sell the asset and lease similar assets as the need arose.⁴

5.12 CSIRO have also been able to encourage more astute facilities management by operating an internal leasing scheme, whereby all occupants of buildings are charged a lease fee based on long term commercial rental rates. CSIRO permits managers to use any savings they make through managing their use of buildings.⁵

5.13 Accrual accounting can also assist managers in determining appropriate expenditure on asset maintenance. Professor Bob Officer, former Chairman of the Victorian Commission of Audit, told the Committee that when agencies do not have to measure heritage or national estate assets, there is often an inclination to disregard them and treat them as either costless or, at the other extreme, invaluable. In either case, agencies have no rational basis upon which to direct resources to their maintenance, and consequently decisions about asset maintenance are likely to be misdirected.⁶

5.14 One of the more notable benefits of accrual accounting for the New Zealand Government has been described by New Zealand's Minister for Finance as being the ability to better manage debts owing to the Government and payments made by the Government to its creditors:

Comprehensive accounting records are now maintained for all elements, and in particular debtors and creditors. This has provided efficiencies in debt collection, management of creditor payments and cash. An independent study suggests

4 CSIRO, *Submission*, p. S1976. The case study appears at Appendix VI.

5 CSIRO, *Submission*, p. S1976. This case study also appears at Appendix VI.

6 Professor Bob Officer, *Transcript*, p. 215 (Melbourne, 10 April 1995).

the savings associated with cash management alone would pay for the total systems development effort required for the move [to an accrual accounting system] ...⁷

Management of Liabilities

5.15 The identification of liabilities in the financial statements is an integral component of the accrual method. Liabilities are defined as '... the future sacrifices or economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events.'⁸ Liability recognition enables the determination of, and thus more informed management of, the full cost of outputs and the level of future commitments.

5.16 The issue of liability recognition was addressed by ANAO in *Audit Report No. 34, 1992-93, Project Audit, The National Bankcard - Who Will Pay the Piper? - A Report on the Financial Obligations of the Federal Government*. In this report the Auditor-General recommended that, as part of the budget process, the Commonwealth should disclose the unfunded liability for superannuation of Commonwealth employees⁹. Other liabilities can include unpaid bills and employee entitlements to recreation and long service leave.

5.17 If governments are to control the effect of today's liabilities on future generations, those liabilities must be identified and accounted for in the financial statements. Governments are then in the position of being able to make fully informed decisions about whether or not to make current provision for all or some of its future liabilities.

5.18 Liability recognition is also essential to help determine the full cost of outputs. The Committee received evidence that

7 Rt Hon Bill Birch, MP, Public Accounts: Accrual accounting in central government - The New Zealand experience, *The Parliamentarian*, April 1995, p. 115.

8 Exhibit No. 40, AARE, *Exposure Draft No. 62: Financial Reporting by Governments*, p. 45.

9 Auditor-General, *Audit Report No. 34, 1992-93*, Recommendation No. 5, p. xvi.

identifying the value of liabilities is important in determining the full cost of the programs and that unless such costs are identified, any decisions about the scale of programs cannot be totally informed. Managers need to be aware of all costs in order to make effective decisions.¹⁰

Cost of Outputs

5.19 Only when costs are known can they be adequately controlled or charged for. Accrual accounting provides more complete information about the full cost of programs, enabling better decision making. As Russell Walker, from the Victorian Auditor General's Office, explained to the Committee:

*In the past there has been far too many decisions made by government based just on a cash cost of programs. A lot of costs have not been brought to account or identified as part of those programs, such as superannuation, rent and accommodation costs that may be met by central agencies. So they have not been allocated back to programs and therefore decisions have been made by governments not based on complete information.*¹¹

5.20 By revealing the true cost of a program or activity, and any variations over time, accrual accounting can provide essential information for agencies seeking to determine a schedule of fees on which to base user-charges. In its submission, the Attorney General's Department stated that they moved to an accrual accounting system in 1992-93 following the introduction of user pays for the Department's Legal Practice. The Department was very positive about its experience with accrual accounting, stating:

... it was important, in terms of establishing fee schedules and appropriate rates of return, that the Legal Practice was able to identify the full cost especially the costs associated with the consumption of assets ... in providing legal services. Had the Legal Practice been unaware of the full cost of providing services, it would have been unable to structure a fee schedule which would ensure full cost recovery and the provision of funds to

10 Steven Mitsas, Victorian Auditor-General's Office, *Transcript*, p. 183 (Melbourne, 10 April 1995).

11 Russell Walker, *Transcript*, p. 184 (Melbourne, 10 April 1995).

*enable the timely replacement of assets.*¹²

5.21 Identifying the true cost of program delivery or service provision is important not only for those who charge for their services, but also for those agencies and managers considering the costs and benefits of contracting-out certain elements of a program, or leasing rather than owning facilities.¹³ These are every day decisions for very many Commonwealth agencies, large or small, and as the Management Advisory Board (MAB) has remarked:

*The potential of accrual accounting to facilitate improved costing[s] ... suggests that it is an essential requirement for all agencies undertaking such activities.*¹⁴

5.22 The attribution of what until now have been centralised corporate costs to individual program areas gives rise to a number of questions about the continuing relevance of separate 'Corporate Services' programs within agencies. If a key focus of

12 Attorney General's Department, *Submission*, p. S1993. This case study appears in Appendix VI.

13 An example of how accrual information can help reveal the true cost of service provision was provided to the Committee by Mark Wood, from the accounting firm Coopers & Lybrand:

... [An organisation in New South Wales] decided that part of their area should be commercial and should charge for what they do. They worked out that to provide what they do was \$37 an hour and they were providing it to internal users, to other departments in New South Wales and to external users at about \$50 an hour. They subsequently found out that when they actually fully costed what they did, it was about \$150 an hour; that is what it really cost them. So every hour they were providing, it was \$100 out of the taxpayers' pockets to help them provide what they were doing. If it was internal, that was one issue. But when it was external, which was 90 per cent of what they did, obviously that was another issue.

14 *The Australian Public Service Reformed*, MAB, p. 318.

the financial management reforms is to encourage managers to run programs more efficiently and to be held to account for their performance, then there is a strong case to say that program managers should have the delegated responsibility to make decisions about the deployment of all of the resources used in delivering program outputs. In this event, there is little need for separate 'Corporate Services' programs.

Performance Improvement

5.23 A key value of accrual information is that can be used to compare aspects of performance over time and between entities. Some of the specific comparisons which can be made were described in the previous chapter.

5.24 The importance of accrual accounting in this context is that managers will have information available to them on a regular basis, perhaps monthly. This means that managers will be able, throughout the course of a reporting period, to compare and better control the performance of their program against benchmarks of best practice.

5.25 The incentive for managers to reflect best practice is that such information will also be available to senior management and external reviewers, such as parliamentary committees and the Auditor-General.

5.26 This concept was summed up in evidence to the Committee, by Trish Mercer, of the Department of Employment, Education and Training (DEET), who stated:

I think they [managers] will see the value of ... being able to see where they then place their resources. They will be able to say, 'it is much more profitable', or be able to compare the performance in one region with another - and that ability to compare performance across areas will not be available simply within one area; it will be available to our own executive also. ... There may be incentives to improve performance because of a knowledge that there is much more performance information available to the executive of the department.¹⁵

Balancing the Costs and Benefits

Introduction

5.27 There has been little disagreement in the evidence put to the Committee that, in theory, Commonwealth agencies would derive much benefit from using accrual information as a day to day management tool.

5.28 However, as only five out of the 65 agencies which operate from the Public Account have made significant progress towards managing on an accrual basis, it is clear that the practice does not yet match the theory.

5.29 There appear to be two main reason why agencies have been reluctant to adopt full accrual accounting:

- a residual view that although accrual accounting is important for commercial operations, its relevance to non-commercial operations or to agencies with few assets is limited; and
- a practical concern that the costs of implementing accrual systems exceed the benefits which can be expected to be derived from such systems - managers with such views argue that balance day conversions to produce annual accrual reports are more cost-effective than adopting accrual accounting.

5.30 The ANAO gave expression to these reservations when, in evidence to the Committee, the then Acting Auditor-General, Bill Nelson, said that although:

... it does not necessarily hold that all agencies ... should use accrual accounting ... [however] medium to large agencies would, in our view, have to use accrual accounting throughout the year to produce accrual reports in the most efficient manner ... [and] get the benefit of the accrual information throughout the year ...¹⁶

5.31 Mr Nelson emphasised that for smaller agencies the costs of running a complex accrual system may be prohibitive.

5.32 Similar concerns were expressed by the Treasury, speaking as a policy advising agency with comparatively few assets:

*We acknowledge that accrual information provides for a more complete picture of the financial situation of an organisation at any given time. The real issue is whether that benefit is material for an agency like Treasury.*¹⁷

and further, at a public hearing:

*... subject to a small number of exceptions, we do not expect accrual accounting to offer major gains in internal, day to day management.*¹⁸

The Committee's View on Relevance

5.33 On the issue of relevance, the Committee disagrees with the contention that accrual information is relevant only to commercial enterprises or agencies with significant asset holdings. As described at various points throughout the report, accrual accounting offers more than just better asset management. This point has been emphasised by MAB in *The APS Reformed*:

Accrual accounting ... is not only about managing assets better ... it is also about increasing the accessibility of information on the activities of government. For that reason it has bearing on the debate surrounding the parliamentary scrutiny of programs, as essentially the accrual system offers an added dimension to the reporting

17 Treasury, *Submission*, p. S1897.

18 Dr Alan Preston, Acting Secretary to the Treasury, *Transcript*, p. 318 (Canberra, 22 May 1995).

*information available. It also needs to be linked to performance information in a balanced MIS [management information system] which provides information relevant to each level of management.*¹⁹

5.34 The former Secretary, of the Department of Administrative Services, Noel Tanzer, has approached the issue from a different perspective, arguing that:

*There is considerable scope for the application of full cost based accrual accounting in many areas of government. It is very effective where there are resource allocation constraints requiring full cost analysis for rationalisation or redistribution. Accrual accounting in these circumstances makes cash-based systems look blunt instruments indeed.*²⁰

5.35 The APS reform process has touched all areas of government activity and agencies, irrespective of their size and the nature of their operations, are being confronted on a regular basis with such decisions as whether to contract out for services, whether to charge for the services they provide, or whether to lease rather than own facilities.

5.36 In this environment it is difficult to envisage a situation where information about the full cost of service provision (that is, accrual information) would not be useful to agency and program managers.²¹

19 *The Australian Public Service Reformed*, MAB, p. 315.

20 Exhibit No. 37, p. 6.

21 In his 1992 'Annual Research Lecture in Government Accounting' Ian Mackintosh quotes another author on this point:

*To argue that accrual accounting is not relevant to departments is, in effect, to argue that neither the cost of service (and therefore efficiency of operations) nor the identification, control and management of economic resources is relevant to Parliament and other views (Ian Mackintosh, *Accrual Accounting for Departments and the Whole of Government: Costs, Benefits and Opportunities*, Australian Society of Certified Practising Accounts, November 1992, p. 27.)*

5.37 The culture of continuous improvement generated by these reforms also demands that agencies benchmark their performance, including financial performance, against other Commonwealth agencies and comparable agencies in other jurisdictions.

5.38 As MAB acknowledge, information about comparative performance levels and the cost of service delivery also enables agency managers to make more visible their stewardship of public resources.

The Committee's Views on Costs

5.39 The Committee acknowledges that the costs of moving from cash to accrual based accounting systems can be significant.²² For some agencies, particularly small agencies, the systems redevelopment and staff training costs may appear prohibitive.

5.40 However, it is important that concerns about implementation costs be balanced by consideration of the benefits of such systems. To a large degree the costs are short term (like systems redevelopment and staff training), whereas the benefits are long term (better asset management, cost control and performance improvement).²³

5.41 In their recent public comments on the matter both ANAO and Finance have urged agencies to address the longer term benefits in evaluating the use and importance of accrual concepts.²⁴

22 Noel Tanzer, the former Secretary of the Department of Administrative Services, is quoted in *The New Financial Reports of Agencies*, as saying that the move to accrual accounting 'has been neither cheap or easy for DAS. (Exhibit No. 37, p. 6.)

23 A recent OECD study on accrual accounting in five countries, including Australia has noted that 'Benefits are also likely to accrue over a longer time period compared to costs which will be greatest when systems are first established. (Exhibit No. 12, *Accounting for What? The Value of Accrual Accounting to the Public Sector*, OECD, Paris, 1993, p. 12.)

24 ANAO, *Submission*, p. S1650 and Exhibit No. 37, p. 58.

5.42 The Committee also notes with interest the concluding paragraph in Finance's guide to the use of accrual reporting and accounting, *The New Financial Reports of Agencies*, which reads:

The incremental nature of public sector reforms introduced in recent years (which have been required to be supported by progressively more comprehensive financial information) has enabled most of the up-front costs associated with the introduction of accrual accounting to be met. Thus the marginal benefit from the introduction of more systematic and integrated accrual accounting systems is likely to be high.²⁵

5.43 In an international study of accrual reporting and accounting the Organisation for Economic Co-operation and Development (OECD) has reported that experience in other countries which tend to confirm this assessment.²⁶

5.44 Another perspective on the question of costs is to consider the risk to which agencies may be exposed by not implementing accrual accounting systems.

5.45 The information in accrual reports will undoubtedly be used by central agencies, principally Finance, and external users as an additional element in the process of holding agencies to account. Agencies may be exposing themselves to significant levels of risk if they were to operate during the year on a cash or modified cash basis, but be held to account at the end of the year, or at any point during the year, for the management of all resources at their disposal.

25 Exhibit No. 37, pp. 58-9.

26 Exhibit No. 12, p. 12.

5.46 As a final observation, it is interesting to note that those Commonwealth bodies for whom cost control is paramount (that is, government business enterprises) implemented accrual-based accounting systems long ago. These organisations made the judgement that the costs associated with changing accounting systems would be recovered quickly by the sort of efficiencies that accrual information can point to. It is ironic that most budget funded agencies, which have a guaranteed income stream (that is, an annual appropriation), have yet to make the move.

Conclusions

5.47 There are significant advantages to be gained from the use of accrual information in day to day management decisions. The advantages can be realised by all agencies, irrespective of their size or the extent of their asset holdings.


5.48 It is also important to recognise that the opportunities to improve financial performance by inter-agency benchmarking are cumulative. So while the efficiencies and improvements generated in small agencies may themselves be small, the overall result may be significant.

5.49 In order for the information to be readily and regularly available to managers, agencies will almost certainly need to institute accrual accounting systems. Although the cost of changing accounting systems should not be underestimated, neither should the benefits which can be derived from such systems.

5.50 The Committee agrees with the assessment by the Acting Secretary to the Treasury at one of the Committee's hearings:

There is absolutely no doubt in our mind that it is the right way forward. It would be a backward step now to move away from accrual accounting. There are benefits to various agencies. There are benefits to whole of government. There is clear evidence around the world of a move to accrual accounting. Economists are steeped in accrual accounting in their economic concepts rather than cash based concepts. I see absolutely no prospect for going backwards on this ...²⁷

27 Alan Preston, Acting Secretary, Treasury, *Transcript*, p. 330 (Canberra, 22 May 1995).



ENCOURAGING THE MOVE TO ACCRUAL ACCOUNTING

Introduction

6.1 The Committee considers that there are compelling reasons for agencies to adopt accrual accounting. Given the overall benefits, the Committee would expect agency heads to embrace accrual accounting. However, there is ample evidence that most agencies have either not yet acknowledged the benefits of accrual accounting, or are placing a low priority on its implementation.

6.2 This chapter considers whether more can be done to encourage agencies to adopt accrual accounting.

The Strategy to Date

6.3 To date the strategy employed by Finance in guiding the reform process has been to introduce changes in a measured and steady fashion, with the aim of inducing a cultural change in the way public sector finances are managed.

6.4 As Pat Barrett, then Deputy Secretary of Finance, explained to the Committee:

... we have learnt from the implementation of the reforms in the last decade that, unless you take along those people with you and get them committed, I suspect you are in a situation of the old adage, 'Garbage in, garbage out.' That is not what this parliament and, certainly, not what individual managers want to have, where they have been used to, I think, a well-trusted and robust cash based system. ... We have seen the need ... for a cultural change within the public sector that suddenly starts to think in these [accrual] terms. Many people, for 10, 20, 30 years or

more, have been thinking in quite different terms. It is not something that you can get overnight and it is not something that you can mandate.¹

6.5 It is apparent that the necessary cultural change has not yet been engendered. Most managers have been untouched by the requirement to prepare accrual reports and few have any appreciation that accrual information can be used in day to day management.

6.6 The ANAO advised the Committee that the follow-up audit, *Audit Report No. 16, 1994-95*:

... found that only a small percentage of agencies indicated that their executive (16%) and program managers (8%) use accrual-based information in financial management decision-making and program administration ... [and] approximately 60% of those surveyed had no plans to introduce the use of accrual-based information in the next two financial years or had no intention to do so.²

6.7 This evidence was confirmed by the Ernst & Young survey which found that:

Although respondents could identify with the benefits of accrual reporting, over 30% of respondents who prepared accrual financial statements saw no other use in their organisation other than to satisfy a legislative reporting requirement.³

6.8 Evidence like this is not encouraging. Until managers use accrual information the reform cannot truly be said to have been successful. In the Committee's view, the Government cannot rely solely on an evolutionary process to induce cultural change if it wants to extract maximum value from the reform. More needs to be done and a more proactive strategy needs to be considered.

6.9 The remaining sections in this chapter comment on

1 Pat Barrett, Finance, *Transcript*, pp. 30-1, (Canberra, 13 February 1995).

2 ANAO, *Submission*, p. S1649.

3 Exhibit No. 6, p. 5.

some of the suggestions which have been made about how to encourage the introduction of accrual accounting. The first part considers the support and assistance which could be offered to agencies; the second part considers issues which may have an incentive effect on agencies; and the final part comments on some broad developments which may influence the pace of change.

Help to Agencies

Education and Support

6.10 Agency and program managers need to be shown how accrual information can assist them in achieving their objectives. This should be a key focus for Finance and agency heads.

6.11 Finance advised the Committee of its action 'to take a leading role in exposing the benefits of accrual reporting, at all levels, and at each suitable opportunity.' The initiatives undertaken by Finance have included:

- presentations by Finance officers to departments, including regional offices;
- presentations by Finance officers to external seminars and conferences;
- articles promoting accrual accounting in FISC (an APS wide newsletter with a management improvement focus) and the publication of *The New Financial Reports of Agencies* (which is aimed at 'demystifying accrual based information and explaining its analytic strengths');
- holding a briefing for senior managers; and
- the circulation to agency heads of details of a training package on financial management based on accrual concepts.⁴

6.12 As discussed in Chapter 4, these have been appropriate strategies which seemed to have been well received and successful.

4 Finance, *Submission*, pp. S1266-7.

6.13 The Committee is pleased to note that Finance has begun to change the focus of its training activities and is now offering a greater number of courses aimed at users of accrual information, rather than just preparers of accrual reports.⁵ This emphasis should be further developed in conjunction with the recommendations in Chapter 4 about a marketing campaign aimed at external users. The effectiveness of training for accrual management would be enhanced by reference to examples of how accrual information has been used as an aid to effective management in public and private sector organisations.

6.14 Finance should also expand its currently limited program of Senior Executive Service training. Senior executive officers are a crucial target group if the pace of reform is to be increased.

6.15 **Recommendation 4**

The Department of Finance should further refine its training strategy to:

- (a) include less of a focus on preparing accrual reports and more of a focus on using accrual information as a management tool; and*
- (b) include specifically tailored courses and material for senior executive officers.*

6.16 The Committee recognises that the education of senior executives and middle managers in matters accrual is not Finance's responsibility alone - agencies themselves need to do more in this area. This issue is referred to again later in this chapter.

Assistance with Implementation Costs

5 In the period between 21 July to 31 December 1995 Finance expect to offer 83 training courses on accrual issues, 18 of which will be directed at 'officers who will be required to interpret financial reports'. This represents an absolute and proportional increase in the number of user focussed courses since courses were first provided in May 1995. (See, Finance, *Submission*, p. S1999.

6.17 As noted in Chapter 5, changing from a cash based accounting system to an accrual based accounting system can often require changes to be made to an agency's financial management information systems. The cost of such changeovers can be great - both in terms of the amount of money paid for new computer software and also the amount of time invested in installing and trialing new systems and training staff how to use them. For small agencies these costs may represent a significant proportion of their total annual budget.

6.18 To date the Government has not made any special budgetary allocation to help agencies make the transition - agencies have had to fund any upgrades needed to meet the accrual reporting requirement out of their existing appropriations for running costs.⁶

6.19 The Commonwealth's approach is in contrast to that adopted in New South Wales and Victoria, where agencies have been able to seek supplementary budget funding to help meet the costs of new information technology systems.⁷ A number of witnesses to the inquiry suggested that similar supplementation should be made available to Commonwealth agencies to assist in the move to accrual accounting.⁸

6.20 Such funding arrangements could be applied not just to meeting the costs of systems upgrades, but also to provide short term staffing assistance to agencies to allow relevant policy development and training activities to be conducted. This would be in the nature of seed funding to help agencies, particularly small agencies, over the hurdle of the up-front costs.

6 Pat Barrett, Finance, *Transcript*, p. 26 (Canberra, 13 February 1995).

7 Michael Lambert, Secretary, New South Wales Treasury, *Transcript*, pp. 127-8 (Sydney, 21 February 1995); Frank King, Deputy Secretary, Victorian Department of the Treasury and Finance, *Transcript*, p. 171 (Melbourne, 10 April 1995).

8 ABS, p. S1828; Defence, p. S1776; and DEET, p. S1998.

6.21 As an alternative to additional funding, the Auditor-General has suggested that agencies should consider seeking, from Finance, an interest free loan.⁹

6.22 Under the current running costs arrangements agencies are able to borrow from their future appropriations. In some circumstances, agencies may make such borrowings without incurring an interest charge.

6.23 The running costs system allows for both single and multiple year borrowings by agencies. The borrowing limit is up to 10% of an agency's total running costs budget from any one year, although borrowings in excess of 10% can be negotiated in exceptional circumstances. Borrowings in excess of 6% of running costs, and any borrowings over multiple years, require agencies to negotiate a resource agreement with Finance. Single year borrowings do not incur an interest charge, while multiple year borrowings attract an interest rate of 8% per annum.¹⁰

6.24 The ability to negotiate resource agreements provides agencies with a degree of flexibility which is not always available in the annual budget process. Such agreements are often used to fund the initial cost of relatively large one-off items (such as computer systems). Typically, resource agreements require agencies to repay the loan and any interest charges from its running costs appropriations over an agreed period.¹¹

6.25 Consideration should also be given to arrangements which would help agencies share the research and development costs associated with new financial management systems. Finance could sponsor a joint working party to examine and make recommendations about appropriate financial management information systems, for say, small and medium sized

9 Auditor-General, *Transcript*, p. 365 (Canberra, 22 May 1995).

10 Finance, *Running Costs Arrangements Handbook*, July 1995, p. 10. A resource agreement has been defined as 'an agreement for the provision of resources in return for some action, an undertaking to act, or some other consideration. (See MAB-MIAC, *Resource Agreements No. 4*, June 1991, p. 1)

11 MAB-MIAC, *Resource Agreements*, p. 4.

agencies. Alternatively a group of agencies with similar characteristics could examine and make recommendations about appropriate financial management information systems, for say, small and medium sized agencies. In this regard, the Committee is aware that a working group has been established, under the direction of the Office of Government Information Technology to review the use of corporate information systems in agencies (for example, financial management, personnel management and payroll systems) with a view to achieving more integrated systems.

6.26 All of these suggestions have merit and warrant further investigation.

6.27 **Recommendation 5**

The Government should consider:

- (a) *providing supplementary funding to agencies to help them redevelop their financial management systems so as to provide full accrual accounting functionality; and*
- (b) *making interest free loans available to agencies to help in the transition from cash based accounting systems to accrual based accounting systems.*

6.28 **Recommendation 6**

The Department of Finance should:

- (a) *consider sponsoring a joint working party to examine and make recommendations about appropriate financial management information systems for small and medium sized agencies; and*
- (b) *facilitate meetings of agencies with similar characteristics with the aim of encouraging the agencies to share the costs of implementing new financial information systems by pooling their research and development resources in a joint pilot project.*

6.29 **Recommendation 7**

The Office of Government Information Technology should expedite work on the review of Commonwealth personnel and financial management systems and take account of the need for full accrual accounting functionality in any integrated management system proposed by the review group.

External Incentives

A Charge on Assets Held

6.30 In evidence to the Committee it was suggested that agencies would be encouraged to implement accrual accounting if an annual capital charge were levied on agencies, with the amount of the charge based on the value of the assets held by each agency. Such regimes currently operate in Victoria and New Zealand.

6.31 A capital charge was introduced by the New Zealand Government in July 1991, so as to:

... encourage departments to manage their balance sheets more actively, disposing surplus assets and looking for opportunities to change the mix of assets to produce their services more efficiently.¹²

6.32 In New Zealand the capital charge is based on the Government's weighted average cost of capital and is levied on the average net asset holding of departments, as recorded in their statement of financial position. Departments allocate the capital charge across their outputs consistent with their use of assets to generate those outputs. The system also allows offsetting transactions between the New Zealand Treasury and

12 Exhibit No. 18, Professor Ian Ball, *Reinventing Government: Lessons Learned From the New Zealand Treasury*, in *The Government Accountants Journal*, Fall 1994, p. 22.

departments to prevent changes to the cost of government services to the taxpayer - the capital charge was designed to be a management rather than a fiscal measure.¹³

6.33 The Victorian Commission of Audit also recommended a capital charge when it investigated Victoria's financial position. The Commission found that the:

*Current budget sector capital expenditure and asset management practices [had] resulted in excess and inappropriate asset holdings, inadequate management and maintenance of public assets and significantly under-utilised assets.*¹⁴

6.34 The Commission proposed that the capital charge should be levied on all existing capital assets to allocate the cost of using capital to operating agencies, and that agencies should be given the discretion to sell these assets or find alternative uses for them. In addition, the Commission suggested that a charge should be levied on all assets used by agencies but not controlled by them.¹⁵

6.35 Professor Bob Officer, the Chairman of the Victorian Commission of Audit and now Professor of Finance at the Melbourne Business School, said in evidence to the Committee:

*I can remember we strongly recommended a capital charge for assets. ... It horrified me that they thought they had these assets as free assets. But that is how they were treating them. They did not behave as though they had capital tied up in those assets. We found that land and things like that were being let for peppercorn rental. It was not done in any devious sense - it was perhaps leased to a local group but the true value of the land and the alternative uses of it were not appreciated.*¹⁶

13 Victorian Commission of Audit, *Report of the Victorian Commission of Audit*, Volume 2, May 1993, pp. 257-8.

14 *Report of the Victorian Commission of Audit*, Vol. 2, p. 257.

15 *Report of the Victorian Commission of Audit*, Vol. 2, p. 310.

16 Professor Bob Officer, *Transcript*, p. 215 (Melbourne, 10 April 1995).

6.36 He added that one result of Victoria's current capital charge of eight per cent has been the rationalisation of land controlled by agencies.¹⁷

6.37 Support for the introduction of a capital charge for the Commonwealth came from Brian Kimball, a senior manager with the accounting firm Ernst & Young, as he felt it satisfied 'the need for a degree of stick to be in the system'.¹⁸ Evidence from Finance indicated that preliminary consideration is being given to the introduction of a capital charge on Commonwealth agencies.¹⁹

6.38 However, a note of caution has been raised in an Audit Office of New Zealand report which drew attention to possible manipulation of assets in order to reduce the amount of capital charge levied. The risks were:

- 'that revaluation policies may be misused'; and
- 'that departments may rationalise their assets through "sale and leaseback arrangements"'.²⁰

6.39 It is also worth noting in the context of this chapter, that a charge on assets held is not intended primarily as a means of encouraging agencies to introduce accrual accounting systems, rather its focus is on better asset management. Nevertheless, a capital charge may encourage agencies to move to accrual accounting in order to better monitor asset use and performance.

6.40 The Committee acknowledges that the proposal to impose a capital charge has some merit, but, as its implications are broader than the focus of this report, it is not appropriate, at this stage, to recommend that such a charge be levied. Instead, the matter should be subject to further consideration.

17 Professor Bob Officer, *Transcript*, p. 227 (Melbourne, 10 April 1995).

18 Brian Kimball, Ernst & Young, *Transcript*, p. 72 (Canberra, 13 February 1995).

19 Pat Barrett, Finance, *Transcript*, p. 43 (Canberra, 13 February 1995).

20 Exhibit No. 29, The New Zealand Audit Office, *Report on the Audit of the Crown and Government Departments for the year ended 30 June 1992*, p. 25.

6.41 **Recommendation 8**

The Department of Finance should consider the appropriateness of levying a charge on agencies for the public assets they hold and use, as a means of encouraging agencies to properly value and efficiently manage their assets.

Parliamentary Scrutiny of Accrual Reports

6.42 It was suggested in evidence to the Committee that the extent to which external users, like parliamentarians and the media, actually use information from accrual reports will influence significantly the pace at which agencies move to accrual accounting:

... the parliament will have available to it better information about some of the operations of departments. And it is that use of the reporting information and applying pressure back on departments to analyse their own management performance ... that will be part of the whole evaluation process.²¹

6.43 The Committee agrees that external scrutiny can be a powerful incentive to action.

6.44 If agency heads and senior managers know that they will be questioned, at the end of a reporting period, by parliamentary committees or the media on their financial position and performance compared to other agencies, they will become increasingly interested in having accrual information available during the reporting period so as to better manage their performance.

The Financial Management and Accountability Bill

6.45 Another possible incentive effect may be found in the package of legislation to replace the Audit Act.

21 Dean Wallace, Finance, *Transcript*, p. 44 (Canberra, 13 February 1995).

6.46 The Financial Management and Accountability Bill, which is one element of the new package, contains two provisions which may encourage agencies to consider a quicker move to accrual accounting.

6.47 The first, Clause 45 of the Bill, requires Chief Executives to manage the affairs of their agency in a way which promotes the 'efficient, effective and ethical' use of Commonwealth resources.

6.48 For the reasons advanced in earlier chapters, the Committee believes that accrual accounting is an indispensable aid to management in today's APS. Without regular access to accrual information it will become increasingly difficult for agency heads (Chief Executives) to demonstrate that they are operating in the most efficient and effective way possible.

6.49 The second relevant provision is Clause 51(1), which states:

A Chief Executive must, when required by the Finance Minister, give the Finance Minister financial statements covering a period of less than a financial year. The Finance Minister may require the statements to include some or all of the details that are required to be included in the annual financial statements.

6.50 For an agency which prepares accrual reports by converting data from cash accounts, the prospect of the Minister for Finance requesting accrual based reports during the course of a financial year would not be especially welcome. The information could no doubt be provided, but to devote resources to such a conversion more than once a year would raise questions about the cost effectiveness of continuing with cash based systems.

Other Influences

Introduction

6.51 There are three other developments which may influence decisions in relation to accrual accounting: the impact of whole of government reporting; the implications of the Council of Australian Government's (COAG) review of government service provision; and the longer term prospects of a move to adopt accrual budgeting.

Whole of Government Reporting

6.52 As discussed in the following chapter, the next step in the Commonwealth's financial reform process is to consolidate all of the agency level accrual accounts and produce accounts for the whole of the government. The timetable for whole of government reporting has not yet been settled, but it may be in place, at least in draft form, as early as 1995-96.

6.53 It is likely that the production of whole of government reports would be coordinated centrally with only minimal additional input from agencies. However, should the Commonwealth decide to produce whole of government reports more frequently than once a year, there will be added pressure on agencies to introduce full accrual accounting systems so as to be able to produce accrual reports quickly and effectively.

6.54 It is interesting to note, in this context, that in New Zealand (the country with the longest experience of such reporting) whole of government reports are currently produced on a monthly basis.

The COAG Review of Service Provision

6.55 In July 1993 the COAG commissioned a review of government service provision. The main task of the review is to:

... develop agreed national performance indicators for key services delivered by governments in Australia, and to collect and publish data for these indicators ... efficiency indicators measures [would] relate outputs to inputs and measure the extent to which resources are being used to best advantage in producing outputs.²²

6.56 The service areas selected as the focus of the review are schools, vocational training, hospitals, community services, public housing, police, courts and correctional services.

6.57 The publication of an agreed set of performance indicators, and data for these indicators, for each area of service provision is intended to enable governments to assess the overall effectiveness and efficiency of the services provided within their jurisdiction.²³

6.58 The relevance of the COAG review is threefold:

- first, it confirms that the drive to improve public sector efficiency is continuing and is likely to be continuous;
- secondly, to contribute effectively to the COAG review, Commonwealth agencies will need to provide information about the unit cost of service provision (this will require the recognition of all of the costs associated with program delivery); and
- thirdly, the review will produce effectiveness and efficiency indicators against which Commonwealth agencies will be assessed.

These factors combined will provide further incentives for Commonwealth agencies to adopt systems to enable them to accurately identify and monitor all of the resources they use.

22 Exhibit No. 48, Industry Commission, *Media Release - Review of Commonwealth and State Government Service Provision*, pp. 1-2.

23 Exhibit No. 48, pp. 1-2.

*Accrual Budgeting*Introduction

6.59 A number of witnesses suggested to the Committee that the most effective way of moving agencies to full accrual accounting would be for the Commonwealth's budgetary process to be changed so that it reflected accrual concepts.

6.60 At present, agencies prepare budgets and seek appropriations on a cash basis, which does not cover accrued costs like provision for depreciation or accrued employee entitlements. In essence the budget process is one of distributing cash to government agencies to finance government programs and other obligations, such as staff salaries and interest payments.

6.61 In an environment where end of year agency reports are on an accrual basis, and where whole of government reports on an accrual basis are being contemplated, a cash based budget process is increasingly out of step and, it is said by some, out of date.

6.62 Trish Mercer of DEET told the Committee that she did not believe there were 'sufficient incentives to move to accrual accounting unless there are serious attempts to look at accrual appropriations.'²⁴ This view was supported by representatives from ABS:

One of the important ways of driving change is to move further down the path of accrual budgeting. It then brings the whole process into coherence. We certainly have a number of problems currently trying to deal with some

*issues on a cash basis, some on an accrual basis. From our management point of view we would find bringing the whole lot on to an accrual basis a desirable direction to go.*²⁵

6.63 Further expressions of support for the principle of constructing budgets on an accrual basis came from the Commonwealth Treasury and in a submission from the Western Australian Treasury.²⁶

Experience Elsewhere

6.64 There have been some steps toward the preparation of accrual budgets in other Australian jurisdictions - for example, the Victorian Commission of Audit recommended a complete overhaul of the Victorian Government's financial system:

*A system of full financial [accrual] accounting should be introduced, which attributes all the costs of delivering a service. Appropriations and financial reporting should be in this format. Budget papers should disclose the full cost of funding a defined set of outputs.*²⁷

6.65 Similar reforms were considered by the South Australian Commission of Audit which, in April 1994, recommended that:

The government should proceed without delay to introduce accrual based financial reporting ... At the same time the

25 Ivan King, ABS, *Transcript*, p. 299 (Canberra, 12 April 1995). See also ABS, *Submission*, p. S1825.

26 For example, Alan Preston, Treasury, *Transcript*, p. 334 (Canberra, 22 May 1995); and the Treasury of Western Australia, *Submission*, p. S1756. Representatives from the Public Sector Accounting Standards Board also supported the need for more comprehensive accrual based budget reporting. (See Ian McPhee, PSASB, *Transcript*, p. 343 (Canberra, 22 May 1995).

27 *Report of the Victorian Commission of Audit*, Vol. 1, p. 152.

*government should integrate these accounting changes with its budgetary procedures to ensure that the full benefits of the accrual method are available.*²⁸

6.66 The Treasurer of New South Wales, the Hon Michael Egan, MLC, has recently announced that the budget for the New South Wales Government will, in future, be presented on two bases: 'a presentation, based on public finance standards ... and an accrual or commercial approach based on Generally Accepted Accounting Principles and Australian Accounting Standards'.²⁹ Specifically, the Budget Papers will include, among other statements:

- *projected accrual financial statements for the Budget year, namely a projected statement of financial position, operating statement and cash flow statement; [and]*
- *outputs, outcomes and resource cost for each program for the Budget year and the three previous years.*³⁰

6.67 Evidence from the Western Australian Treasury intimated that planning was underway for the implementation of accrual budgeting in that jurisdiction:

*Accrual budgeting is seen as the logical progression following accrual accounting and accrual budgeting arrangements will be formulated once agencies have appropriate accounting and financial management systems in place to facilitate accrual accounting as opposed to accrual reporting.*³¹

6.68 In the international context, the governments of New Zealand and Iceland are currently appropriated funds on an accrual basis, while the United Kingdom Government has indicated its intention to move to accrual budgeting by the year 2000.

28 South Australian Commission of Audit, *Charting the Way Forward: Improving public sector performance - Overview*, April 1994, p. 35.

29 Hon Michael Egan, MLC, *Financial Statement*, June 1995, p. 30.

30 Hon Michael Egan, MLC, *Financial Statement*, June 1995, p. 28.

31 Treasury of Western Australia, *Submission*, p. S1756.

6.69 In New Zealand, the change to accrual budgeting reflects the government's interests as a purchaser of outputs from departments at an efficient price. When bidding for funds departments have to provide statements of projected performance and projected accrual based financial statements.³² Parliament thus has available to it information showing the input of proposed departmental activities on non-cash items such as assets and liabilities, and appropriations are made against those items.

6.70 The UK Government released a green paper in July 1994 which set out proposals for departments and agencies to account for their expenditure on an accruals basis by 1998 and prepare their budgets on a similar basis from 2000.³³ An inter-departmental committee was subsequently created to undertake an 'efficiency scrutiny' of departmental planning systems.

6.71 The results of the scrutiny were released in May 1995. The report noted that the focus of the UK government's initiatives were on improved resource management which was indicative of the changing emphasis in UK Government financing 'away from planning and budgeting for the cost of inputs to using resources more efficiently to generate outputs.'³⁴

6.72 The first recommendation of the scrutiny report was that, 'the business cycle of planning, budgeting, monitoring and reporting should be undertaken as an integrated process.' It also recommended that senior managers be able to 'obtain detailed information about the running of departments and agencies, as and when required.'³⁵ As the report explained:

32 Exhibit No. 12, p. 11.

33 *Better Accounting for the Taxpayer's Money: Resource Accounting and Budgeting in Government*, Cm 2626, HMSO, July 1994.

34 Exhibit No. 47, Efficiency Unit Cabinet Office, *Resource Management Systems - An Efficiency Unit Scrutiny*, HMSO, May 1995, pp. 10 and 13.

35 Exhibit No. 47, pp. 3 and 5.

Budgeting and monitoring are two sides of the same coin. Senior management needs to be able to monitor the progress of the organisation against budget: equally managers need to monitor the progress of the organisation against budget. Good management systems serve both purposes in that the same information can be accessed by managers at different levels of aggregation: they enable senior managers to receive aggregate information but also to dig down into increasing detail if they wish.^{36,37}

6.73 The Federal Government in the United States is also developing accounting standards which will identify the full cost of government programs and incorporate accrual concepts in their accounting, reporting and budgetary systems.³⁸

The Committee's Observations

6.74 The Committee acknowledges that a desire to encourage agencies to implement accrual accounting and management systems, is not sufficient reason in itself to change the basis or which appropriations are made. A change in this magnitude would require consideration not just of accounting issues, but also of such fundamental questions as the nature of

36 Exhibit No. 47, p. 26.

37 The management advantages of accrual budgeting were also highlighted by Kevin Riley from Coopers & Lybrand when he briefed the Committee:

We view [accrual budgeting] as being essential to being part of your top-down planning. If we have operational plans - any department would be able to show you their corporate plan and operating plans - accrual budgeting is really just costing those activities and putting dollars on them. People know when their cash information is going to happen: accrual budgeting is just looking at the activities we are delivering, and when, and putting some dollar figures on them. Linking the operation and planning financial budgeting gives greater accountability. It allows management to make some valid decisions and say, 'are we providing these services as efficiently as we possibly can ...?'

38 See Federal Accounting Standards Advisory Board, *Managerial Cost Accounting Standards for the Federal Government, Statement of Recommended Accounting Standards, Exposure Draft*, October 7, 1994, pp. 4-5, and *FASB News*, Issue No. 31, May 1995.

the relationship between the Government and its bureaucracy.

6.75 Nevertheless, there is now a basic incoherence in the Commonwealth's financial management system - funds are appropriated on a cash basis, but end of year reports are made, mainly, on an accrual basis. The problem with such a system is not just its inelegance, but that it sends mixed messages.

6.76 It is understandable that agency managers are inclined to focus on cash, after all it is cash which they have been appropriated. Yet at the same time agencies are increasingly being held to account for more than just their performance in managing cash. In these circumstances it is more difficult than it need be for managers to determine the full extent of their obligations and focus their performance accordingly.

6.77 It is important, as one observer of the New Zealand Government's financial management system has noted, that the different elements of the system interact in an integrated and consistent fashion:

An obvious, but in a government financial management context frequently ignored, example is the need to measure performance ex post in a manner consistent with ex ante agreements, whether those agreements are specified in budgets or in some other contractual or quasi-contractual arrangement. The problems created by ex post and ex ante marching to a different beat are plain enough. Decision makers face conflicting signals and incentives, and their performance will normally reflect this. The sort of inconsistency I am identifying also reflects a lack of clarity over objectives.³⁹

6.78 While it is undoubtedly possible, at least in the short term, for agencies to operate within a financial management framework which provides cash appropriations and calls for accrual reports, there is a risk that such a system will undermine, or at least limit, the potential of the reforms undertaken to date.

6.79 In the Committee's view, there are good reasons for the Commonwealth Government to consider changing the basis on which appropriations are made. In summary, they are that:

- there are advantages and efficiencies to be gained from operating in a financial system, the various components of which are integrated;
- managers will be hampered in their attempts to perform efficiently if they continue to receive confusing signals about what Parliament and the Government are interested in; and
- it is inappropriate that Parliament has no formal role in making decisions about the use and management of non-cash resources.⁴⁰

6.80 **Recommendation 9**

The Government should commission or undertake a major review of the Commonwealth's system of budget appropriations to consider the merits or otherwise of altering the system to require that budgets be prepared and appropriations be made on an accrual basis.

Conclusions

6.81 More can and should be done to help agencies move to accrual accounting. This chapter has described some of the steps which should be taken to educate managers and provide financial assistance, especially to small agencies. The chapter also highlighted some of the factors which may give agencies an incentive to move, and some external developments which may ultimately force the issue.

40 The Committee acknowledges that there are some commentators who argue that cash budgets will always be necessary for central governments because they summarise the government's fiscal policies which are concerned with macroeconomic management of the Commonwealth (see Professor Allan Barton's commentary in Mackintosh, *Accrual Accounting for Departments and the Whole of Government: Costs, Benefits and Opportunities*, pp. 70-71).

6.82 It seems to the Committee that the combination of current and expected future circumstances will soon make the adoption of full accrual accounting an integral part of good public sector management. The issue is no longer if agencies will make the move, but when.

6.83 Notwithstanding these circumstances, the success of these final stages in the reform process will be influenced significantly by the commitment shown by key decision makers in government and within agencies.⁴¹

6.84 The Government should make a clear and unambiguous statement of direction about the value of full accrual accounting and the importance of accrual management. Evidence from other jurisdictions in Australia and overseas indicates that commitment from the highest levels in government is an essential element in the reform process.⁴²

6.85 If such commitment is absent or equivocal, confusion and uncertainty will result and the prospects of success will be

41 The ABS has argued in its submission to the Committee that, if agencies are to be encouraged to use accrual information as a management tool, key decision makers must lead by example: 'the government and parliament should insist on accrual based information for all monitoring, reporting and evaluation purposes; the senior management of agencies should use accrual based management information for all internal evaluation and monitoring purposes'. (ABS, *Submission*, p. S1830) A similar observation was made by Kevin Stevenson, from Coopers & Lybrand, who asserted that the excuses made for slow progress to date can be attributed mainly to a 'lack of resolve' on the part of senior management. (Kevin Stevenson, *Transcript*, p. 195, (Melbourne, 10 April 1995).

42 The following quote from the New Zealand Minister for Finance exemplifies this point: '[the] reform model and process have been strongly supported by both successive governments and oppositions. This contributed to both the swiftness and success in implementing and refining these reforms. In New Zealand, implementation of accrual accounting with departmental entities was scheduled to take two years ... However, the adjustment was achieved smoothly and the last department made the change six months ahead of the statutory deadline.' (Rt Hon Bill Birch, MP, Public Accounts: Accrual accounting in central government - The New Zealand experience, *The Parliamentarian*, April 1995, p. 115.

diminished.

6.86 This statement of direction should be taken up and reinforced at a strategic level by Finance and, within each organisation, by agency heads. A coordinated series of information and education campaigns, of the type described in paragraphs 4.34 and 4.35 should be launched in support of the Government's statement of direction.

6.87 The Committee agrees with the sentiment expressed in a submission from ABS:

There comes a time when agencies are as ready as they ever will be and to delay is to squander the opportunities.⁴³

6.88 **Recommendation 10**

The Government should make a statement stressing the value of accrual information as an aid to effective management of public resources and supporting the move toward full accrual accounting for Commonwealth agencies.

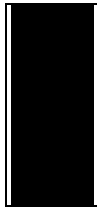
6.89 **Recommendation 11**

All agency heads should:

- (a) commit themselves and their agencies to the implementation of accrual management systems and practices; and*
- (b) prepare detailed implementation plans to guide the development of accrual management systems and practices in their agencies - including statements of systems re-development requirements, staff training requirements, and target dates for the achievement of key milestones.*

6.90 The Committee intends to review, twelve months after the tabling of this report, a sample of agencies to test their performance in implementing accrual accounting systems and accrual management practices.

43 ABS, *Submission*, p. S1831.



WHOLE OF GOVERNMENT REPORTS

Introduction

7.1 Whole of government reporting is a form of general purpose financial reporting where the financial statements of the various entities controlled by a government are consolidated to show the financial activities and performance of the government as a whole.

7.2 The preparation of such reports is analogous to the position in the private sector where large corporations present to their shareholders a consolidated set of financial statements showing the activities and performance of all entities within the group.

7.3 The process of consolidating the financial reports of government agencies first requires agencies to consolidate all the financial statements of trust accounts, companies or other bodies controlled by them, and then requires the government to combine the statements of all agencies. Specifically, the process involves:

- *aggregating revenues, expenses, assets and liabilities of all bodies in an economic entity; and*
- *eliminating any transactions and balances between those bodies in order to avoid double counting.*¹

1 Exhibit No. 37, p. 30.

7.4 Such reports, which are usually based on accrual concepts, contain information about:

- the total expenses and revenues of government operations;
- total asset stocks available to the government;
- total debt levels and financing costs associated with current government activities and, possibly, contingent obligations which may require future financing; and
- cash inflows and outflows.

7.5 The Commonwealth Government does not at present prepare accrual based whole of government financial reports. However, a number of witnesses referred to such reporting as an important development in the accounting reform process and a logical extension of the implementation of accrual reporting in agencies.

7.6 This chapter outlines:

- some of the recent developments in whole of government reporting;
- considers whether whole of government reporting would be useful in the Commonwealth context;
- identifies some of the issues which need to be resolved should the Commonwealth move towards the production of whole of government reports; and
- comments on the process of developing relevant and reliable whole of government reports.

Recent Developments in Whole of Government Reporting

The General Environment

7.7 Few governments in the world and only one in Australia (that is, New South Wales) produce whole of government reports on a regular basis.

7.8 In New South Wales, the preparation of whole of government reports was prompted by a report, in 1988, from the New South Wales Commission of Audit, which had been established by the incoming Griener Government to examine the State's finances. The Commission reported that knowledge of the

State's financial position was incomplete and would be enhanced by:

- preparation of annual balance sheets for the budget sector and statutory authorities;
- identification of the overall state deficit and consolidated fund deficit on an accruals basis; and
- the identification of the public sector borrowing requirement.²

7.9 The Commission's recommendations were adopted and the first whole of government report for New South Wales was published in December 1989, covering the years 1987-88 and 1988-89.³

7.10 In June 1995, the Treasurer of the newly elected Carr Government in New South Wales, the Hon Michael Egan MLC, announced that the whole of government reporting process would be further developed to allow:

... a half yearly release of Consolidated Financial Statements for the general government sector, public trading enterprises sector and the total State sector. The Consolidated Financial Statements [will] provide financial information on an accrual basis.⁴

7.11 There have also been moves toward regular whole of government reporting in other Australian jurisdictions, the most notable being:

- the publication of a whole of government report for Victoria for 1991-92 by the Victorian Commission of Audit (which had been appointed by the incoming

2 New South Wales Treasury, *Consolidated Financial Statements of the NSW Public Sector 1987/88 and 1988/89*, December 1989, p. 1.

3 *Consolidated Financial Statements of the NSW Public Sector 1987/88 and 1988/89*, December 1989, p. 1.

4 The Hon Michael Egan MLC, Financial Statement, June 1995, p. 28.

- Kennett Government);⁵
- an indication from officials that the Government of Victoria would be in a position to publish annual whole of government reports beginning in 1996-97;⁶ and
 - the release in August 1995 of the first in an intended annual series of whole of government reports by the Government of Western Australia.⁷

7.12 The most advanced example of whole of government reporting at the national level is in New Zealand, where governments have prepared such reports since 1991-92. The measure was one of a number of economic and financial reforms introduced following a currency crisis and downgrading of the New Zealand Government's credit rating in the mid-1980s.

7.13 The New Zealand Government made a clean sweep of the former cash based financial management and reporting systems and introduced a coordinated and coherent series of accrual based reforms - of which whole of government reporting is a key element. A leading commentator on the New Zealand financial reform process has said that:

We developed our accounting systems not just to produce good accounts, but because we believe that better accounting could contribute to improved performance in government.⁸

5 *Report of the Victorian Commission of Audit*, Vol 1, pp. 217-235.

6 Frank King, Victorian Department of the Treasury and Finance, *Transcript*, p. 157 (Melbourne, 10 April 1995).

7 The Treasury of Western Australia, *Submission*, pp. S2003-5.

8 Exhibit No. 18, p. 21.

7.14 There are signs that other countries also are moving to prepare whole of government reports: the Canadian Government presented a whole of government report for the first time in 1993-94;⁹ and indications are that the United Kingdom and the United States are at various stages in the development of such reports.^{10,11}

The Accounting Standard

7.15 In Australia the move towards whole of government reporting has been encouraged by AARF, which over the last two years has been preparing an accounting standard for whole of government reporting.

7.16 AARF has described the development of this standard as 'filling the last of the major voids in public sector financial reporting':

... most entities in the "budget and non-budget sectors" in the public sector are now preparing or are moving towards the preparation of full accrual-based general purpose financial reports. The final piece of the "mosaic" will be in place when all of that information is combined and governments prepare comprehensive information about their assets, liabilities, revenues and expenses.¹²

7.17 Mr Frank Micallef, the Director of AARF's Whole of Government Reporting Project, told the Committee that the Standard would provide a common set of rules and definitions for all governments in Australia and 'improve the possibility to

9 Exhibit No. 42, Richard Chan, *Report on Whole-of-Government Financial Reporting*, A paper for the Australian National Internships Program at the Australian National University with Finance, November 1994, p. 95.

10 Pat Barrett, Finance, *Transcript*, p. 28 (Canberra, 13 February 1995).

11 For further information about the international situation as it applied in 1993 see, Exhibit No. 12.

12 AARF, *Submission*, p. S1946.

make some meaningful comparison across jurisdictions.¹³

7.18 The process of developing a standard for whole of government reporting began with the release in November 1994 of a discussion paper which identified the issues to be addressed in the preparation of such reports and recommended approaches to their resolution.¹⁴

7.19 In March 1995 AARF published an exposure draft of its proposed standard (*Exposure Draft 62 - Financial Reporting by Governments*).¹⁵ AARF's intention is that, after a period of public comment, the draft will be finalised and issued by 30 June 1996 and, for government's complying with the Standard, is required to be adopted for the reporting period ending 30 June 1998.¹⁶

Is Whole of Government Reporting Useful?

What Do Whole of Government Reports Provide?

7.20 Like the agency level accrual reports on which they are based, whole of government reports would recognise an economic event when it occurs, irrespective of whether the event is associated with a flow of cash.

7.21 Also like accrual reports, whole of government reports would contain an operating statement, a statement of financial position, a statement of cash flows and information about assets, liabilities, revenues and expenses.

7.22 Because the information in whole of government reports is consolidated, it can generate macro level information about the financial position and performance of governments. Ultimately it can lead to the calculation of the net worth of the government.

13 Frank Micallef, AARF, *Transcript*, p. 348 (Canberra, 22 May 1995).

14 Exhibit No. 11, AARF, p. 1.

15 Exhibit No. 40.

16 AARF, *Submission*, p. S1953.

7.23 More importantly though, the information presented in whole of government reports can be used as an aid to strategic decisions about the management of governments. As one official from Finance remarked to the Committee, the significance of such reports is that they focus essentially on the full resource usage of the Government and help reveal 'whether we are running down assets or whether we are building up our capital base or whether we are simply just consuming ourselves out of existence'.¹⁷

7.24 Consolidated accrual information may, for example, show that a purely cash surplus is more than offset in any one year by a build up of liabilities. By pulling together information from all entities within government, whole of government reports may also highlight options for managing debt levels which would not otherwise have been obvious.

7.25 The New Zealand Minister for Finance, the Rt Hon Bill Birch MP has argued that the regular preparation of consolidated reports has significantly improved the quality of information provided for decision making by Ministers.¹⁸ In talking about the range of financial and service performance information which is contained in the whole of government reports prepared in New Zealand, Mr Birch remarks that:

*We can [now] ... tell whether assets managed by the Crown are being built up or eroded, and whether any build up is in terms of investment in infrastructure, heritage assets or government business.*¹⁹

17 Phil Bowen, Finance, *Transcript*, p. 393, (Canberra, 22 May 1995).

18 Rt Hon Bill Birch MP, 'Public Accounts: Accrual accounting in central government - the New Zealand experience', *The Parliamentarian*, April 1995, p. 113.

19 Rt Hon Bill Birch, MP, 'Public Accounts: Accrual accounting in central government - the New Zealand experience', p. 114.

7.26 Some other specific examples of how whole of government reports can be used are:

- to reveal whether there may be inequity between present and future generations in relation to the utilisation of assets, especially those that are finite;²⁰
- to enable the creation of a model whole of government system allowing policy makers to test the effect of various scenarios on future government balance sheets;²¹
- to provide information detailing all of a government's liabilities which would be valuable for monitoring compliance with Loan Council limits;²² and
- to provide information of value to the Commonwealth in assessing the performance of the States when using the resources provided by the Commonwealth.²³

7.27 Whole of government reporting also facilitates a more sophisticated accountability process, in that Parliament and others can call the Executive to account for its management of the full range of public resources.

7.28 As discussed earlier, traditionally parliaments have focussed their authorisation and scrutiny processes on cash. Given the diversity and complexity of modern government this is too limited a view. As one commentator has remarked:

... if we are happy with this [limited conception of accountability] it is implicitly accepting a position where the parliament cedes a great deal of authority over resources to the executive. It cedes the right to take decisions which do

20 Auditor-General, *Transcript*, p. 369 (Canberra, 22 May 1995).

21 George Carter, Finance, *Transcript*, p. 396 (Canberra, 22 May 1995).

22 Exhibit No. 11, p. 24.

23 Exhibit No. 11, p. 25.

*not involve cash flows, but which may significantly affect the financial position of both the government and taxpayers.*²⁴

7.29 In the Committee's view, Parliament has a clear interest in all of the resources used by the Government and it is appropriate that the Government should report on the manner in which such resources are managed.

7.30 The importance of these broad notions of accountability and transparency were referred to frequently in evidence to the Committee and a number of specific examples of how whole of government reporting could enhance these processes were suggested. It was said that such reporting would:

- discourage 'creative' budget solutions, such as those generated by extracting additional dividends from or shifting debt to government-owned enterprises, and resource consumption by writing off debt owed or gifting assets;²⁵
- enable the Government and the Parliament to better evaluate the success of particular government programs and to determine future resource allocations;²⁶
- enable the public to judge whether the Government's priorities in the allocation of resources accord with their own and the relative merits of government and Opposition policies on future resource allocation;²⁷
- convey to the public the financial standing of a government as an aid to gaining support to reform;²⁸

24 Exhibit No. 45, Professor Ian Ball, Victoria University of Wellington, *Whole of Government Reporting - Presentation to the Australasian Area Auditor-General, Hobart*, March 1995, p. 4.

25 Exhibit No. 32, p. 15.

26 Exhibit No. 11, p. 21.

27 Exhibit No. 11, p. 22.

28 Tony Harris, Auditor-General for New South Wales, *Transcript*, p. 105 (Sydney, 21 February 1995). The Auditor-General was referring to the situation in New Zealand when one of the early whole of government reports revealed that the NZ Government had a

and

- provide information to credit rating agencies and government financiers to enable an assessment of a government's present and likely future financial position.²⁹

Can This Information be Provided by Current Financial Reports? Can This Information be Provided by Current Financial Reports? Can This Information be Provided by Current Financial Reports?

7.31 An important issue to address in this context is whether the other forms of consolidated financial reporting which are currently available provide the same sort of information as would be available through whole of government reporting.

7.32 The present system of consolidated government level reporting in Australia includes:

- the System of National Accounts (the National Accounts);
- the Government Financial Statistics (GFS);
- the Budget Papers; and
- the aggregate statements prepared by the Minister for Finance.

7.33 The purpose of each of these forms of reporting was considered by AARF in its discussion paper, *Financial Reporting by Governments (DP21)*. AARF also assessed whether these reports provided information like that available in whole of government reports. Its conclusions were that:

- although the National Accounts are prepared using accrual concepts, the purpose of the Accounts is to provide information for use in macro-economic sector and industry based analyses. The information is not

negative equity. This had enabled the marshalling of public support for subsequent measures introduced by the NZ Government.

presented in a form which focusses on individual governments as distinct reporting entities and it is not possible to recast the figures to reveal such information;³⁰

- GFS financial reports do recognise governments as separate and distinct reporting entities, however, they exclude the financial institutions sector of government and, at present, are largely cash based;^{31,32}
- the Budget Papers are primarily projections of expected activity rather than financial reports of past transaction; focus primarily on the 'budget sector' and do not comprehensively comment on government businesses or financial institutions, are directed at securing a cash appropriation; and are not audited;³³ and
- the Minister for Finance's statements include an audited report of cash flows through the Public Account compared to parliamentary appropriations, but they include little or no information about assets, liabilities or charges, about revenues and expenses, or about non-budget entities.³⁴

7.34 The Committee concurs with AARF's assessment that none of the current consolidated financial reports fulfil all of the purposes envisaged for whole of government reports.

Conclusionss

7.35 The Committee believes that whole of government

30 Exhibit No. 11, pp. 80-1.

31 Exhibit No. 11, p. 82.

32 The ABS, which compiles GFS, has recently advocated that GFS move 'to an accrual basis (with supplementary cash based statistics) as soon as possible'. See Exhibit No. 36, ABS, *Introduction of an Accruals Basis in Government Finance Statistics*, 1995 Government Finance Statistics Conference, p. 12.

33 Exhibit No. 11, pp. 74-6.

34 Exhibit No. 11, pp. 78-9.

reporting would be very useful in the Commonwealth context.

7.36 Whole of government reports would contain information of value to Cabinet, to the Government's key economic and financial advisers, to parliamentarians and to many other external users. They would help inform strategic

decisions about government priorities and policies, and would enable the Government to better account for its use of public resources.

7.37 An added benefit as more States and Territories move toward the preparation of whole of government reports, is the potential to make useful comparisons between different Australian jurisdictions.

7.38 The Committee believes the Government should commit itself to the preparation, at least annually, of whole of government reports for the Commonwealth.

7.39 **Recommendation 12**

The Government should commit itself to the preparation, at least annually, of whole of government reports for the Commonwealth.

Issues to be Addressed in Moving to Whole of Government Reporting

7.40 In evidence presented to the Committee there was little argument about the merits of whole of government reporting. However, a number of witnesses argued that it was important for whole of government reports to be credible documents containing meaningful figures, and accordingly that any conceptual or policy problems need to be settled before such reports are published.

7.41 Some of the uncertainties which currently exist will be addressed in part by the accounting standard for whole of government reporting when it is released. Other issues which will need to be considered include the following:

- the need to define the limits of government control and hence which entities should be included in the consolidation;³⁵
- the lack of certainty concerning the compatibility of different agency figures;^{36,37}

35 Tony Harris, NSW Auditor-General, *Transcript*, pp. 102-3 (Sydney, 21 February 1995).

36 Pat Barrett, Finance, *Transcript*, p. 37 (Canberra, 13 February 1995).

- the need to eliminate inter-agency transactions to prevent double counting of activities;³⁸
- inaccuracies within agency reports which would be compounded if those reports were consolidated;³⁹
- the need to ensure the consistent treatment of certain streams of liabilities and assets, such as superannuation, future welfare payments and future streams of taxation;⁴⁰ and
- the need to determine the statistical parameters used, for example, whether information should be expressed on a per capita basis or as a percentage of gross domestic product, to enable comparison between governments and countries.⁴¹

7.42 Clearly, these and perhaps other issues need to be resolved before credible and reliable whole of government reports can be produced. But as the OECD has observed, these problems are not insurmountable - they have been addressed and overcome in other countries.⁴² It is interesting to note the New Zealand experience in this regard. The Chief Finance Officer in the New Zealand bureaucracy has said that 'the problems perceived in prospect are a great deal more daunting than the actual problems experienced, when viewed in retrospect'.⁴³

37 Professor Bob Officer, Past Chairman of the Victorian Commission of Audit, *Transcript*, p. 220 (Melbourne, 10 April 1995).

38 George Carter, Finance, *Transcript*, p. 39 (Canberra, 13 February 1995).

39 Geoffrey Applebee, Ernst & Young, *Transcript*, p. 69 (Canberra, 13 February 1995).

40 Phil Bowen, Finance, *Transcript*, p. 387 (Canberra, 22 May 1995).

41 Exhibit No. 12, p. 15, referring to Barrett, P J, *Managing in an Accrual Environment*, a paper presented to a conference of the Royal Australian Institute of Public Administration, 26 February 1993.

42 Exhibit No. 12, p. 15.

43 Exhibit No. 45, p. 3.

The Implementation Process

7.43 As noted above, the Commonwealth has yet to commit itself to the preparation of whole of government reports. Nevertheless, officials from Finance have been involved in the development of the proposed accounting standard for whole of government reporting and have been participating in work on the subject being undertaken by the Standing Treasuries Liaison Committee.

7.44 In evidence to the Committee there was some discussion about a possible timetable for the implementation of whole of government reporting for the Commonwealth. There was consensus between ANAO and Finance that the earliest likely start-up date for full reporting was the year ending 30 June 1998. This is consistent with the start-up date proposed by AARF. A timeframe of this magnitude should allow the sort of problems identified in the previous section to be resolved.

7.45 The then Deputy Secretary of Finance and now Auditor-General, Pat Barrett, advised the Committee that he would expect that in the years leading up to 1997-98, draft, and probably unaudited, whole of government reports would be produced and, subject to the approval of his Minister, discussed with relevant parliamentary committees.⁴⁴

7.46 The Committee believes that such trial consolidations would help resolve some of the conceptual policy issues referred to above. A program of consultation with interested parliamentary committees would also be appropriate and may help refine the form and content of whole of government reports.

7.47 The Committee also believes that the implementation process would be expedited and given a sharper focus by the adoption of a formal implementation plan, incorporating target dates for key milestones.

44 Pat Barrett, Finance, *Transcript*, p. 38, (Canberra, 13 February 1995).

7.48 **Recommendation 13**

At the same time as announcing a commitment to prepare whole of government reports, the Government should announce an implementation plan incorporating target dates for the achievement of key milestones.

Further Review by the Committee

7.49 The Committee believes that the implementation of whole of government reporting is an important step for the Government to take and one which is entirely consistent with the direction of the financial management reform process initiated in the mid-1980s.

7.50 We are hopeful that the Government will agree to take the next step and build on the preliminary work which has already been done.

7.51 There remains much work to be done and, as the Auditor-General has noted, Parliament and its committees can play a useful role by considering and commenting on issues as they emerge during the implementation phase. The Committee has, therefore, decided to maintain its involvement in the subject and conduct a separate, and more detailed, review of:

- the timetable for the implementation of whole of government reporting for the Commonwealth; and
- the information which should be contained in whole of government reports for the Commonwealth.

7.52 The Committee intends to present a report on these matters during the course of the current Parliament.

Les Scott, MP
Chairman
23 August 1995