The Parliament of the Commonwealth of Australia

Joint Committee of Public Accounts

REPORT 341

FINANCIAL REPORTING FOR THE COMMONWEALTH

Towards Greater Transparency and Accountability

November 1995

Australian Government Publishing Service
Canberra

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Sectional Committee Secretary:	Ms S Johnston
Inquiry Staff:	Mr S Frawley Mrs Y Rao Mr C Lawson Ms D Christophers Mr R Morris

[1] The Financial Reporting Sectional Committee was responsible for conducting inquiries into whole of government reporting and fiscal responsibility legislation for the Commonwealth.

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.

TERMS OF REFERENCE

On 31 May 1995 the Joint Committee of Public Accounts resolved to undertake inquiries into the following issues.

Whole of Government Reporting

The Committee shall examine and report on the implementation of whole of government reporting for the Commonwealth of Australia, with particular reference to:

- 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.

Fiscal Responsibility Legislation

The Committee shall examine and report on whether it is necessary or appropriate to legislate for fiscal responsibility at the Commonwealth level, with particular reference to:

- the success of attempts to legislate for fiscal responsibility in other jurisdictions; and

- the relevance to the Commonwealth of the type of public reporting provisions contained in fiscal responsibility legislation in other jurisdictions.

CONTENTS

Chapter

LIST OF ABBREVIATIONS

AARF	Australian Accounting Research Foundation
ABS	Australian Bureau of Statistics
ANAO	Australia National Audit Office
AWE	Average Weekly Earnings
BBA	Balanced Budget Amendment
BOOT	Build, Own, Operate, Transfer
CBO	Congressional Budget Office (USA)
CFT	Commonwealth Government Statement of Financial Transations
CPI	Consumer Price Index
ED 62	Exposure Draft 62 - *Financial Reporting by Governments*
EPAC	Economic Planning and Advisory Council
Finance	Department of Finance
GASB	Governmental Accounting Standards Board (USA)
GBE	Government Business Enterprise
GDP	Gross Domestic Product
GFS	Government Finance Statistics
MMP	Mixed Member Proportional (voting system)
NSW	New South Wales
NZ	New Zealand
OMB	Office of Management for Budget (USA)

PFI	Public Financial Institution
PSASB	Public Sector Accounting Standards Board
RBA	Reserve Bank of Australia
STLC	Standing Treasury Liaison Committee
TEL	Taxation Expenditure Limitation
US	United States (of America)

CHAIRMAN'S FOREWORD

In this report, the Joint Committee of Public Accounts maintains the momentum for moving the Commonwealth into an accrual accounting environment.

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. For the 1994-95 financial year, all government budget-sector agencies have submitted annual financial statements on an accrual basis - most for the first time.

The challenge is now to set in place a financial management framework for the Commonwealth as a whole that will be able to utilise the accrual information that has been prepared by government agencies.

The Committee takes up the challenge in this report.

Building on the recommendations contained in its *Report 338*, the Committee proposes in this report that the accrual reports of government agencies - including government business enterprises - should be consolidated into an accrual based whole of government report for the Commonwealth.

Whole of government reporting for the Commonwealth will make the financial position of the Commonwealth more transparent. In particular, since whole of government reports will reveal the Commonwealth's assets and liabilities - and *not just cashflows - it will be immediately apparent if the* government of the day is running down the asset base of the Commonwealth to fund recurrent spending, to the detriment of future generations of Australians.

As important as it is, whole of government reporting is not the final stage in the transition from a cash to an accrual culture. The potential of these reports will not be realised unless there is also a mechanism for feeding this information into financial planning and the Budget.

The Committee is not interested in excellent Commonwealth financial reports that sit on the shelf.

In this report, the Committee proposes a financial reporting framework that ties the Budget process into the accrual environment.

In the Committee' s view, it is important that the Parliament plays a key role in determining the form and content of financial reports tabled. After all, such reports are prepared principally for Parliament's use. The legislative reporting framework proposed in this report makes it clear that it is **Parliament** which should determine the type of financial reports to be presented for its consideration.

I commend this report to the Parliament. By heeding the recommendations in this report, the Government has an opportunity to effect the most significant changes to financial reporting for the Commonwealth since Federation.

In conclusion, and on behalf of the Committee, I would like to express our appreciation to those people who contributed their experience and opinions to the inquiries, often at short notice. I would particularly like to thank George Carter and Lynne O'Brien, our observers from the Department of Finance and the Australian National Audit Office. Finally, I would like to thank the Auditor-General for agreeing to release Simon Frawley, a senior officer from ANAO, to assist us on the whole of government reporting inquiry.

Les Scott MP
Chairman

EXECUTIVE SUMMARY

This report examines the potential improvements to the Commonwealth's financial reporting regime that have been made possible by the recent move to accrual accounting in government departments and agencies.

Accrual accounting activates the possibility of whole of government reports being prepared for the Commonwealth. 'Whole of government' reports consolidate the financial statements of government agencies - including government business enterprises - to give a picture, not only of the government's revenue and expenditure, but also its assets, liabilities, and resulting financial position.

In this report the Committee discusses:

- what it considers to be an acceptable timetable for implementing whole of government reporting for the Commonwealth;
- the form and content of whole of government reports for the Commonwealth;
- how government business enterprises should be shown in Commonwealth financial reports; and
- how the Commonwealth should account for its portfolio of disparate assets.

If whole of government reports are soon to be published and tabled in Parliament, then the Commonwealth should be establishing mechanisms to ensure that the potential of these reports is realised. Whole of government reports promise enhanced scrutiny of public finances and also offer benefits for financial planning and fiscal policy development.

The Committee has considered how accrual based whole of government reports can be most effectively exploited. This report discusses accrual budgeting and the advantages of preparing the Commonwealth Budget on an accrual basis.

The Committee has also considered whether or not it would be useful for the Parliament to specify in legislation the form and content of financial reports to be tabled.

The Committee proposes a model of fiscal reporting that would be appropriate for the Commonwealth of Australia.

The Committee has also examined the possibility of enhanced Parliamentary scrutiny of the government's financial performance. At the moment, parliamentary committees examine the performance - including the financial performance - of individual government departments and agencies, but there is no close examination of the government's overall financial performance (as distinct from the vigorous but partisan debate that takes place on the floor of the Chambers from time to time).

The Commonwealth's financial reports could be subject to inquiry and report by a parliamentary committee established for this purpose.

Recommendations

Recommendation 1

The Government should commit itself to the preparation of audited whole of government reports beginning with the 1997-98 financial year. To achieve this target the following process and timetable should be adopted:

- **1994-95 financial statements - the Department of Finance and the Australian National Audit Office to develop a model and prepare exemplar whole of government reports, in consultation with the Joint Committee of Public Accounts;**
- **1995-96 financial statements - the Department of Finance and the Australian National Audit Office to prepare trial unaudited whole of government reports, the results of which would be referred to the Joint Committee of Public Accounts for review and consideration;**
- **1996-97 financial statements - the Department of Finance and the Australian National Audit Office to prepare trial unaudited whole of government reports, taking into account modifications to the model deemed necessary, the results of which would be referred to the Joint Committee of Public Accounts for review and consideration; and**

- **1997-98 financial statements - the Department of Finance and the Australian National Audit Office to prepare audited whole of government reports.** (paragraph 2.77)

Recommendation 2

The Treasury and/or the Department of Finance should publish a discussion paper on the financial performance indicators to be derived from Commonwealth whole of government reports. The paper should include discussion of what financial performance indicators may be useful in interpreting such reports, what such indicators mean and how they should be interpreted.

The paper should be distributed for public comment and result in a final report to be considered by the Government and the Joint Committee of Public Accounts, prior to the release of the Accounting Standard on whole of government reporting. (paragraph 2.104)

Recommendation 3

The Department of Finance and the Australian National Audit Office should formulate a schedule of all agencies which would come within the ambit of the Commonwealth government reporting entity as defined in the exposure draft Australian Accounting Standard on whole of government reporting.

Further, this schedule should be presented to the Joint Committee of Public Accounts for review prior to the release of the Australian Accounting Standard for whole of government reporting. (paragraph 2.147)

Recommendation 4

The Government should ensure that Government Business Enterprises and Public Financial Institutions within the government reporting entity are included on a full consolidation basis in Commonwealth whole of government reports. (paragraph 2.173)

Recommendation 5

As a matter of priority, the Department of Finance and the Australian National Audit Office should develop a framework for the recognition and valuation of Commonwealth assets managed by Commonwealth agencies. The purpose of such a framework is to ensure that all Commonwealth agencies develop and use consistent asset recognition and valuation policies. The lack of such a framework in the interim should not be viewed as a barrier to proceeding with whole of government reporting.

In moving to whole of government reporting the Government should ensure that:

- only assets that are identified as being useful to a government in achieving its objectives and can be reliably measured, including relevant infrastructure and heritage assets, are recognised and valued;
- where assets cannot be reliably measured they should be given a notional value and listed in an appendix; and
- the methodology ultimately adopted and the reasons for its adoption are clearly stated in whole of government reports. (paragraph 2.197)

Recommendation 6

Commonwealth whole of government reports should be presented in a form consistent with the format specified by the Australian Bureau of Statistics for the Government Finance Statistics.

The Commonwealth Government should seek a commitment from all State and Territory governments for the implementation, in accordance with an agreed timetable, for the preparation of whole of government reports, through the Council of Australian Governments forum.

As part of the commitment it should be agreed that consistent policies and presentation, determined in the Heads of Treasuries forum, will be adopted and applied, as far as is practicable, by all parties. (paragraph 2.210)

Recommendation 7

The Department of Finance and the Australian National Audit Office should analyse, in consultation with the Joint Committee of Public Accounts, the likely costs of obtaining, collating and auditing the information necessary to prepare a note within whole of government reports showing line items of expenditure by functional classification. (paragraph 2.214)

Recommendation 8

The Department of Finance should review what commentary and other information could be included in a readers aid attached to whole of government reports in consultation with the Joint Committee of Public Accounts. (paragraph 2.216)

Recommendation 9

The Department of Finance should ensure that the content and format of whole of government reports for the Commonwealth remain consistent over time to allow for meaningful year to year comparisons.

In particular, consistency should be ensured for:

- the composition of the Commonwealth government reporting entity;
- the method of combining entities within the Commonwealth government reporting entity;
- the methodology for the recognition and valuation of assets; and
- the presentation and display of information within Commonwealth whole of government reports. (paragraph 2.219)

Recommendation 10

As well as supporting the preparation of annual audited whole of government reports by 1997-98, the Government should commit itself to the preparation of unaudited six monthly whole of government reports by 1999-2000. (paragraph 2.229)

Recommendation 11

The Government should ensure that audited whole of government reports are tabled in Parliament within a reasonable time after the end of the financial year and that they stand referred to the Joint Committee of Public Accounts for review. (paragraph 2.240)

Recommendation 12

The Government should prepare and introduce into Parliament legislation to establish a fiscal reporting framework binding on Commonwealth governments, such legislation to be called the *Fiscal Reporting Act.* (paragraph 3.306)

Recommendation 13

The proposed *Fiscal Reporting Act* should require:

a) that fiscal reports be prepared in the form of whole of government reports on an accrual basis; and

b) that the form and content of fiscal reports for the Commonwealth accord with the Committee's recommendations in Chapter 2 of this report. (paragraph 3.307)

Recommendation 14

The proposed *Fiscal Reporting Act* should require:

a) that the Commonwealth adopt accrual budgeting following the tabling of the first audited whole of government reports for the Commonwealth; and

b) that the first accrual budget for the Commonwealth be introduced into Parliament for the 1999-2000 financial year. (paragraph 3.308)

Recommendation 15

The proposed *Fiscal Reporting Act* should require the tabling or publication of fiscal reports of specified format, as follows:

a) that an agreed set of indicators of a government's financial performance - including net debt as a proportion of GDP - be specified in the legislation;

b) that governments be required to report against these indicators their achievements and future policies in each report required under the legislation;

c) that fiscal reports incorporate estimates for the budget year and the following four years of all major fiscal variables (such as net debt);

d) that the fiscal reports specify the macroeconomic assumptions on which estimates are based;

e) that fiscal reports incorporate forecasts or projections for the budget year and the following four years of all appropriate economic indicators on which fiscal estimates are based;

f) that fiscal reports contain a statement of sensitivity of fiscal estimates to economic conditions; and

g) that the format and content of the fiscal reports prepared under this Act remain constant over time to allow historical comparisons. (paragraph 3.309)

Recommendation 16

The proposed *Fiscal Reporting Act* should require the tabling or publication of fiscal reports in accordance with a mandatory reporting cycle, as follows:

a) that governments be required to table a statement three calendar months prior to the day on which the Budget is introduced into the Parliament stating their *Fiscal Strategy* for the coming financial year and the next two years;

b) that, on the day the Budget is tabled in Parliament, the Treasurer table a statement specifying how the Budget conforms with the *Fiscal Strategy*;

c) that, on the day the Budget is tabled in Parliament, the Treasurer table *Budget Papers*;

d) that the *Budget Papers* contain the following information:

- the Commonwealth operating statement, including estimates for the budget year and the following four years;
- the financial position of the Commonwealth, including estimates for the budget year and the following four years;
- the statement of cash flows for the Commonwealth, including estimates for the budget year and the following four years;
- notes to the financial statements including information about contingent liabilities, restricted financial assets and capital expenditure commitments;
- statement of borrowings and other financial commitments; and
- accrual based forward estimates of each government agency funded from Consolidated Revenue;

e) that the operating statement, statement of financial position and statement of cash flows for the Commonwealth, including forward estimates, be updated and published midway through the financial year; and

f) that actual budget outcomes and audited whole of government financial statements be published as soon as they are available. (paragraph 3.310)

Recommendation 17

The proposed *Fiscal Reporting Act* should provide that the Treasury prepare a condensed version of the *Budget Papers*, to be tabled with the *Budget Papers*, in a format which is accessible to the general public and which includes a commentary explaining the meaning of the budget figures to lay readers unfamiliar with economic concepts or accounting terminology. (paragraph 3.311)

Recommendation 18

The proposed *Fiscal Reporting Act* should establish a joint committee of Parliament to examine and report on fiscal reports produced pursuant to the legislation. All fiscal reports would automatically stand referred to this committee for inquiry and report.

The Act should make specific provision for the committee to call relevant Ministers of State to give evidence. (paragraph 3.312)

Recommendation 19

The proposed *Fiscal Reporting Bill* should be referred to the Joint Committee of Public Accounts following its tabling in the House, for inquiry and report. (paragraph 3.313)

Recommendation 20

The Department of Finance and the Treasury should commence discussions in the Heads of Treasuries forum with a view to identifying technical and procedural issues that would need to be addressed prior to encouraging the adoption by all Australian States and Territories of mirror fiscal reporting legislation. (paragraph 3.314)

1

CONDUCT OF THE INQUIRIES

Genesis of the financial reporting inquiries

1.1 On 31 May 1995, the Joint Committee of Public Accounts resolved to conduct inquiries into whole of government reporting and fiscal responsibility legislation for the Commonwealth. A Sectional Committee was appointed to conduct the inquiries.

1.2 The inquiries are at the core of the Committee's responsibility to advise the Parliament on desirable alterations in financial reporting to enhance the accountability of the public sector.

1.3 The inquiries follow the Committee's inquiry into accrual accounting and reporting for the Commonwealth.[1] In August 1995, the Committee recommended to the Parliament, inter alia, that all government agencies should be committed to implementing accrual management systems; that consideration should be given to switching budget appropriations to an accrual basis; and that whole of government financial reports should be prepared for the Commonwealth.

1.4 The suite of accrual accounting reforms proposed in *Report 338* represents a major step in the Commonwealth's transition from an agency focused, cash based accounting environment, to a whole of government, accrual based environment. In this present report the Committee gives further consideration to these issues and discusses the steps needed to complete the transition.

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1 Joint Committee of Public Accounts, *Report 338: Accrual Accounting - A Cultural Change* (AGPS, August 1995).

Focus of the inquiries

1.5 The Terms of Reference for each inquiry are included at the front of this report.

1.6 In the case of whole of government reporting, the Committee had already formed the view in its accrual accounting inquiry that whole of government reporting should be implemented. Accordingly, the present Terms of Reference focus on the **timetable** for implementation and the format and content of whole of government reports. The Committee's conclusions and recommendations on whole of government reporting for the Commonwealth are in Chapter 2 of this report.

1.7 In the case of fiscal responsibility legislation, the Committee came to the inquiry without any view as to whether or not this would be a desirable innovation in financial reporting. The Terms of Reference reflect that this issue is at the starting gate. The Committee's analysis of fiscal responsibility legislation is in Chapter 3 of this report.

1.8 The Committee decided to conduct the inquiries into whole of government reporting and fiscal responsibility legislation concurrently. The main reason for this was that the issues involved in the inquiries were intertwined, as will become apparent in the body of this report. The two inquiries into whole of government reporting and fiscal responsibility legislation for the Commonwealth were effectively merged into one process known as the financial reporting inquiries.

1.9 A secondary reason was that the key interested parties for both inquiries were essentially the same and the Committee sought to minimise the time that would need to be contributed by these persons and agencies.

Gathering evidence

1.10 At the outset of the inquiries, on 27 July 1995, the Committee received an informal briefing from senior executives of the Treasury and the Department of Finance and from the Auditor-General. The Committee was also briefed by the Chairman of the Public Sector Accounting Standards Board, Mr Ian McPhee, in relation to the Exposure Draft Standard for whole of government reporting in Australia. The purpose of these informal briefings was to discuss the Terms of Reference for the financial reporting inquiries and to ensure that the Committee had anticipated the major relevant issues likely to cause concern.

1.11 Following the meeting on 27 July 1995, the Committee Secretariat prepared an Issues Paper, setting out a broad range of questions that the Committee wished to address in the course of the financial reporting inquiries. This was published in August 1995 and distributed to interested parties.

1.12 The Committee placed advertisements in the *Australian Financial Review* of 4 August 1995 and the *Weekend Australian* of 5 August 1995, calling for submissions to the inquiries. The Committee also sent letters inviting participation in the inquiries to around 100 persons and agencies considered likely to have an interest in the matters under review.

1.13 The Committee received 33 written submissions and 34 exhibits to the inquiries, listed in Appendices I and II respectively of this report.[2]

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2 Submissions to a parliamentary inquiry are documents that have been created specifically for the purpose of the inquiry and received as evidence by the Committee; submissions attract parliamentary privilege. Exhibits to a parliamentary inquiry are documents not created specifically for the inquiry, including already published material; exhibits do not enjoy parliamentary privilege.

Copies of submissions are available from the Committee Secretariat up to one month after the publication of the relevant report. Exhibits should be sourced direct from the party providing the material to the Committee.

1.14 The Committee took evidence at five public hearings in Canberra and Sydney. The witnesses at these hearings are listed in Appendix III.

1.15 The financial reporting inquiries were conducted to an extremely tight timetable. The deadlines for submitting evidence were rigid compared to other inquiries conducted by the Joint Committee of Public Accounts, the requests to witnesses to attend public hearings were on relatively short notice; any requests for follow-up information were urgent. The Committee is thus indebted to all contributors for their assistance, without which this report could not have been tabled before the end of the 1995 Parliamentary sittings.

Briefings on international practice

1.16 Australia has had very little practical experience of the matters under review in the financial reporting inquiries. Overseas jurisdictions provided valuable information on whole of government reporting and fiscal responsibility legislation.

1.17 The Committee would like to extend special gratitude to the following people who provided information and briefings on whole of government reporting and fiscal responsibility legislation in their respective jurisdictions.

Canada

- Mr Andy Macdonald, former Comptroller General for the Canadian Government (1988 to 1993).

1.18 On 28 September 1995, the Committee was briefed by Mr Andy Macdonald on whole of government reporting in Canada. Canada has been in the process of implementing whole of government reporting since the 1980s. Mr Macdonald was able to speak authoritatively on conceptual and technical aspects of whole of government reporting.

New Zealand

- Hon Ruth Richardson, former Minister for Finance (1990 to 1993) in the New Zealand Government;
- Mr Graham Fortune, High Commissioner, New Zealand High Commission;
- Dr Trevor Matheson, First Secretary, New Zealand High Commission; and
- Dr Brook Barrington, Second Secretary, Economic, New Zealand High Commission.

1.19 The Committee was briefed by officers of the New Zealand High Commission on 27 July 1995 in relation to the *Fiscal Responsibility Act 1994* (NZ).

1.20 The Committee was briefed by Ms Ruth Richardson on 26 September 1995 in relation to the introduction of fiscal responsibility legislation in New Zealand. Ms Richardson was the architect of New Zealand's fiscal responsibility legislation and the Minister responsible for introducing the Fiscal Responsibility Bill into the Parliament. Ms Richardson also chaired the Finance and Expenditure Committee of the New Zealand House of Representatives while it was inquiring into, and recommending amendments to that Bill. Ms Richardson is an acknowledged world expert on fiscal responsibility legislation.

United States of America

- Mr Paul Van de Water, Assistant Director for budget analysis, Congressional Budget Office;
- Mr Ron Snell, Director, Economic and Fiscal Division, National Conference of State Legislatures;
- Mr Ralph Moore, Economic Counsellor, Embassy of the United States of America;
- Mr Stephen Gangstead, Cultural Attache, Embassy of the United States of America;
- Ms Noeline Milson, Cultural Specialist, United States Information Service;
- Ms Rosemary Dickson, Library Director, United States Information Service; and
- Mr Neil Abraham; Technical Officer, United States Information Service.

1.21 On 26 October 1995, the Committee was able to discuss models of balanced budget legislation, debt limitation provisions, taxation and expenditure limitations, with experts in the budget process at the Federal and State levels in the United States of America. This was made possible by a telephone hook-up to Washington DC and Denver (Colorado) arranged for the Committee by the United States Information Service on behalf of the Embassy of the United States of America.

1.22 Legislatures in the United States have had in place certain forms of legislative fiscal restraints since the 1840s. No meaningful inquiry into fiscal responsibility legislation could fail to take account of the United States' experience. The telephone conference was an excellent opportunity for the Committee to canvass ideas about how elements of the fiscal legislation in the United States might be appropriate for the Commonwealth of Australia.

1.23 The Committee acknowledges its indebtedness to these parties for assisting the Committee to understand overseas models of whole of government reporting and fiscal responsibility legislation. Nonetheless, the Committee itself accepts all responsibility for the information, analysis and comment on overseas models contained in this report except where otherwise explicitly attributed.

2

WHOLE OF GOVERNMENT REPORTING

Introduction

2.1 In this report whole of government reporting refers to the consolidation of the accrual based financial statements of agencies which collectively represent the government as a single entity.

2.2 The preparation of such reports is analogous to the situation in the private sector where corporations are required to present a consolidated set of financial statements showing the activities and performance of all entities within a reporting entity, to their shareholders.

2.3 Whole of government reports would comprise:

- an operating statement showing the total expenses and revenues of government operations;
- a statement of financial position showing the value of assets available to the government and the total obligations of the government;
- a statement of cash flows showing cash inflows and outflows: and
- notes to the financial statements showing disaggregated information and information about items such as contingent liabilities, restricted financial assets and capital expenditure commitments.

2.4 The process of consolidation involves the following steps:

- *identification of what entities need to be consolidated;*
- *aggregation of the financial information of these entities; and*

- *identification and adjustment within the consolidated accounts of differences in accounting policies as well as inter-entity transactions and balances.*[1]

2.5 All Commonwealth government departments were required to prepare annual financial statements on an accrual basis for the year ending 30 June 1995. There is no requirement, however, for this information to be aggregated into financial statements for the Commonwealth.

2.6 Whole of government reporting is considered by the Committee to be a logical extension of agency based accrual reporting.

2.7 This chapter:

- outlines the Committee's preliminary views on whole of government reporting;
- reconsiders the potential benefits and uses of whole of government reports;
- considers a timetable for implementation of whole of government reporting for the Commonwealth;
- examines the indicators of financial performance which can be derived from whole of government reports;
- discusses some of the significant technical issues such as what entities are to be included and how they are to be accounted for; and
- discusses the possible role of Parliament in regard to whole of government reports.

1 P J Barrett, Auditor-General, *Submission*, p. S37.

Background

2.8 The Committee's interest in, and preliminary views on, whole of government reporting were published in *Report 338 Accrual Accounting - A Cultural Change*, tabled in August 1995. *Report 338* noted that a number of witnesses to that inquiry 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.[2]

2.9 *Report 338* recognised that other jurisdictions were moving to whole of government reporting. New South Wales (NSW) and New Zealand were identified as being the most advanced examples of whole of government reporting with other notable movers being Victoria and Western Australia.[3]

2.10 *Report 338* discussed the potential uses of whole of government reports none of which are or can be fulfilled by current consolidated financial reports.

2.11 The Committee found that whole of government reports could, inter alia:[4]

- generate macro level information about the financial position and performance of governments;
- disclose whether assets managed by government were being increased or depleted, and whether any increase was in terms of investment in infrastructure, heritage assets or government business;
- reveal inequities between present and future generations in relation to asset utilisation;
- enable the creation of a whole of government econometric model allowing policy makers to test the various fiscal policy scenarios on future government balance sheets; and
- enable the Government and the Parliament to better determine future resource allocations.

2 Joint Committee of Public Accounts, *Report 338 Accrual Accounting - A Cultural Change*, (AGPS, August 1995) p. 76.

3 *Report 338*, pp. 77-79.

4 *Report 338*, pp. 80-85.

2.12 The Committee went on to recommend:

The Government should commit itself to the preparation, at least annually, of whole of government reports for the Commonwealth.[5]

2.13 In *Report 338* the Committee recognised that a number of policy and technical issues would need to be resolved before meaningful or credible whole of government reports could be published. In the interests of giving a sharp focus to these issues the Committee also recommended:

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.[6]

2.14 This inquiry into whole of government reporting arose out of the Committee's undertaking to maintain its involvement in this subject and conduct a 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]

2.15 These two issues formed the Terms of Reference for this inquiry into whole of government reporting.

2.16 At the outset of its inquiry the Committee was urged to delineate clearly the potential uses of whole of government reports so that the reporting framework and standards ultimately adopted could be designed to meet these ends.

2.17 Although the Committee is wary of the accuracy of the currently available cost information and is inclined to the view that the full utility of whole of government information will emerge as the reports are developed and refined over the next few years, the following section considers again the potential benefits and uses of whole of government reports.

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5 *Report 338*, p. 86.

6 *Report 338*, p. 89.

7 *Report 338*, p. 89.

Use of whole of government reports

Concerns raised with whole of government reporting

2.18 The benefits and uses of whole of government reports were questioned during this inquiry.

2.19 In particular, the following issues were raised in evidence presented to the Committee:

- that the benefits of whole of government reporting have not been demonstrated;
- that no cost/benefit analysis has been undertaken;
- that whole of government reporting across jurisdictions is not comparable;
- that the impact of the concept of materiality would render the result worthless; and
- that the financial statements would be unauditable.

2.20 These concerns are addressed in turn in the following sections.

<u>Benefits of whole of government reporting</u>

2.21 Certain concerns were raised about the actual benefits to flow from whole of government reporting and the underlying reasons for its adoption. Most notably the following points were raised:

- that a case in support of accrual based whole of government reports has not been developed by the standard setters;[8]
- while whole of government reporting sounds attractive in principle its proponents have still to spell out its benefits in concrete terms;[9] and
- whether or not parliamentarians, the public, the media and others require the degree of information presented in whole of government reports.[10]

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8 Department of Finance (Finance), *Submission*, p. S85.

9 B W Fraser, Governor, Reserve Bank of Australia, *Submission*, p. S183.

10 B M Rollason, Auditor-General of Queensland, *Submission*, p. S180.

2.22 In response, the Public Sector Accounting Standards Board (PSASB) of the Australian Accounting Research Foundation (AARF), the body responsible for setting public sector accounting standards in Australia, contends:

> *... that there is a strong case for governments to account for the resources under their control and the obligations they have incurred, and to disclose the financial effect of decisions taken during the year. This would be consistent with the trend to more open and accountable government, promoted as a key element in public sector reforms in Australia.*[11]

2.23 This argument was supported in other evidence where it was suggested that whole of government reporting would:

- aid in appreciation of the long term financial effects of government decisions;[12]
- provide one reference source to enable strategic assessments and planning at government level;[13]
- be useful in medium to long term analysis, for example, in identifying trends which may require government action;[14]
- allow assessments to be made of the performance of governments in their stewardship of resources available to them;[15] and
- enhance the transparency and visibility of government performance and strengthen accountability.[16]

2.24 The PSASB also referred to studies performed in Canada, New Zealand, and the USA, and a study performed by the International Federation of Accountants.

11 PSASB, *Submission*, p. S192.

12 Finance, *Submission*, p. S79.

13 P J Barrett, Auditor-General, *Submission*, p. S36.

14 P J Barrett, Auditor-General, *Submission*, p. S36.

15 D D R Pearson, Auditor General of Western Australia, *Submission*, p. S28.

16 Ernst & Young, *Submission*, p. S175.

2.25 These studies sought to identify who the users of financial reports of governments are and what their information needs are. The findings, according to the PSASB, are consistent with what the PSASB has included in a draft accounting standard for whole of government reporting, *Exposure Draft 62 - Financial Reporting by Governments*[17] (ED 62).[18]

2.26 The need for whole of government reporting is being recognised internationally. The Committee believes the opportunity now exists for Australia to be at the forefront of developments in this area.

Costs of whole of government reporting

2.27 The Auditor-General of Queensland questioned whether or not the additional costs of implementing whole of government reports can be justified when measured against all likely benefits.[19]

2.28 Reliable estimates of the cost of preparing audited whole of government reports could not be presented to the Committee. The Department of Finance (Finance) advised that there would be costs in setting up a system for preparing the consolidated financial statements and structures able to process the information but they are difficult to quantify. Finance continued:

> *Costs incurred by agencies should be relatively small - particularly after the first year. Most costs have already been met because all departments are now at least reporting on an accruals basis at year end, even if they have not yet acquired an accrual based financial system.*[20]

17 Exhibit No. 17.

18 PSASB, *Submission*, pp. S192-94.

19 B M Rollason, Auditor-General of Queensland, *Submission*, p. S180.

20 Finance, *Submission*, p. S82.

2.29 The Auditor-General agreed that it was not possible to comment with any degree of assurance on the costs of implementing whole of government reporting but noted that if new systems were required within Finance and/or individual agencies then the cost could be significant.[21]

2.30 Estimated costings for jurisdictions already preparing whole of government reports were advised by AARF. For New Zealand the annual cost of preparing monthly consolidated financial reports, including printing and audit, was $NZ 380 000. In addition the software and the system New Zealand have set up to do the consolidation cost about $NZ 330 000.[22]

2.31 For NSW, AARF advised the cost of preparing annual whole of government reports, including printing, data entry and audit fees, was $200 000.[23] This is consistent with what the NSW Treasury advised the Committee.[24]

2.32 Coopers & Lybrand advised the Committee that it has been invited to tender for the systems requirements for the consolidation of approximately 600 entities for the Victorian Government. Its estimate of such costs was around $150,000.[25]

2.33 Of course such estimates are not directly transferable to the Commonwealth environment. The size and complexity of Commonwealth operations, vis-a-vis State public sectors, may increase costs, as may different approaches to consolidation (for example, New Zealand only recognises the Crown's ownership interests in commercial enterprises, rather than fully consolidating all assets and liabilities in the Crown's whole of government statements).

2.34 Nonetheless, the experience of other jurisdictions indicates that that the overall systems and administration costs have not proved an obstacle to the implementation of whole of government reporting.

21 P J Barrett, Auditor-General, *Submission*, p. S37.

22 Frank Micallef, AARF, *Transcript*, pp. 51-52 (Canberra, 8 September 1995).

23 Frank Micallef, AARF, *Transcript*, p. 52 (Canberra, 8 September 1995).

24 NSW Treasury, *Submission*, p. S223.

25 Coopers & Lybrand. *Submission*, p. S147.

2.35 In addition the point was made in evidence to the Committee that the establishment costs of the first year can be viewed as an investment which could be written off over a number of years in the benefits to be derived from whole of government reports.[26]

2.36 The Committee concurs with this view and believes that, since all budget sector bodies now report on an accrual basis, the incremental costs of moving to whole of government reporting would be justified in the light of the accountability and management benefits identified above.

Comparability between jurisdictions

2.37 The Auditor-General of Queensland also argued that because there are many legislative and operational differences between public sector entities in different jurisdictions, it is not possible to make valid comparisons between jurisdictions.[27]

2.38 In response the PSASB contends that:

The consolidation process overcomes differences in form (as against differences in substance), such as whether an entity is classified as 'budget sector/budget dependent'.[28]

2.39 The PSASB also believes that differences in substance between jurisdictions, such as one State controlling the electricity provider while another State does not, should be highlighted, not obscured, as it is important that the financial reports of governments reflect the resources they actually control and the obligations for which they are actually responsible.[29]

26 Bill Nelson, Australian National Audit Office (ANAO), *Transcript*, pp. 55-56 (Canberra, 8 September 1995).

27 B M Rollason, Auditor-General of Queensland, *Submission*, p. S180.

28 PSASB, *Submission*, p. S199.

29 PSASB, *Submission*, p. S199.

2.40 The Committee agrees with this view. The financial performance of listed corporations is invariably compared to other corporations with different structures and business interests so there is no reason to suggest that governments, particularly State and Territory governments, cannot be compared.

2.41 The Committee acknowledges that it may be less meaningful to make comparisons between the Commonwealth and State or Territory governments but believes that this is not sufficient reason to challenge the usefulness of whole of government reports.

Materiality

2.42 The Auditor-General of Queensland also questioned the impact of the concept of materiality on whole of government reporting in the following terms:

[ED 62] ... is based on the theory that the entire operations of government would be recorded financially. However, if the principle of materiality is observed as a means of overcoming difficulties in collating financial data, certain areas of government activity would be eliminated from the exercise. In my view, this would render the result worthless as it would not be a true reflection of the whole of government financial activity.[30]

2.43 The PSASB addressed this view by noting that the concept of materiality requires all information that has the potential to affect decision making or the discharge of accountability to be included in the financial report.[31]

2.44 The PSASB continued:

Accordingly, the concept of materiality cannot be used to mask important information, and yet is important to ensure that the level of accuracy required in preparing financial reports is not overly pedantic or costly.[32]

30 B M Rollason, Auditor-General of Queensland, *Submission*, p. S181.

31 *Australian Accounting Standard AAS 5 'Materiality'* discusses the accounting definition of materiality and includes quantitative guidelines.

32 PSASB, *Submission*, p. S198.

2.45 The Committee understands that the concept of materiality applies equally in the private and public sectors and is included in international accounting standards. On this basis it does not appear to be an issue which would prevent the preparation of meaningful whole of government reports.

Difficulty in auditing whole of government reports

2.46 The Auditor-General of Queensland raised concerns about the magnitude and complexity of consolidating whole of government information which 'may very well make the resulting financial statements unauditable.'[33]

2.47 As the PSASB points out, 'Consolidation accounting and auditing techniques are well established across both the private and public sectors, and do not pose significant barriers to whole of government reporting or auditing'.[34]

2.48 The Committee accepts that there might be teething problems in moving to whole of government reporting but that these problems should not prevent the move in that direction.

The New South Wales experience

2.49 The use of whole of government reports in NSW was examined to determine uses and benefits in practice. Within Australia, NSW is the jurisdiction most advanced in development of whole of government reporting, having prepared such reports since 1988.

2.50 In the view of Michael Lambert, Secretary of the NSW Treasury, whole of government reporting has a number of benefits:

The first benefit is that it does focus on the broader question of your balance sheet, your financial position. Secondly, it does encourage a longer term financial planning perspective, and it does tend to push you to look at net worth as a longer term financial target. It also creates a structure in which you can talk about your capital structure policy.

33 B M Rollason, Auditor-General of Queensland, *Submission*, p. S181.

34 PSASB, *Submission*, p. S198.

> ... *Finally it creates a very useful database of financial information in a time series of financial information, not only at the total level but at the individual agency level. This enables you to start to do quite a lot of financial analysis with that information and thus assist forward financial planning.*[35]

2.51 The NSW Auditor-General, Tony Harris, who also supports the preparation of whole of government reports claimed that they have not been used very well and not to a very large extent since they were first prepared in NSW.[36]

2.52 Professor Robert Walker, School of Accounting, University of NSW, supported this view claiming that apart from a 1988 NSW Commission of Audit, it was 'difficult to locate any instances in which the reports have been cited in public debate about policy and resource allocation'.[37]

2.53 Reasons given by the NSW Auditor-General for this situation were as follows:

- there is no legislative framework for whole of government reports;
- there is no legislative requirement that they be audited or tabled;
- because they are not tabled in Parliament there is no parliamentary consideration or debate on them;
- there appears to be a limited understanding in the community about what they are and what they mean; and
- the timing of the audit opinion (23 December 1994 for 1993-94 reports) is such that public interest is minimal.[38]

35 NSW Treasury, *Submission*, p. S218.

36 Tony Harris, NSW Auditor-General, *Transcript*, p. 66 (Sydney, 11 September 1995).

37 Professor Robert Walker, *Transcript*, p. 86 (Sydney, 11 September 1995). See also *Submission*, S153.

38 Tony Harris, NSW Auditor-General, *Transcript*, p. 66 (Sydney, 11 September 1995).

2.54 The NSW experience is illustrative, and certainly points to problems which should be considered in the Commonwealth context, but in the Committee's view it does not represent a persuasive argument against whole of government reporting.

Conclusions

2.55 Notwithstanding all of the concerns raised about the benefits and uses of whole of government reporting and the NSW experience, the Committee endorses the views expressed previously in *Report 338*.

2.56 The Committee remains of the opinion that whole of government reporting would be very useful in the Commonwealth context and that the Government should commit itself to the preparation, at least annually, of whole of government reports.

Timetable for implementation

2.57 To date, the timetable for implementation of whole of government reporting in Australian jurisdictions has been set by the PSASB.

2.58 The timetable for implementation proposed by the PSASB was included in ED 62.

2.59 ED 62 indicated that the proposed operative date of the Standard would be 'two clear years after the date of issue of the Standard'.[39] The PSASB stated that it 'had in mind that the standard would apply to the 1997-98 financial year'[40] although '[t]he standard ... does encourage early adoption as well.'[41]

39 Exhibit No. 17, p. 13.

40 Ian McPhee, PSASB, *Transcript*, p. 41 (Canberra, 8 September 1995).

41 Ian McPhee, PSASB, *Transcript*, p. 42 (Canberra, 8 September 1995).

2.60 The PSASB advised the Committee, however, that it had received comments from some jurisdictions expressing concerns about their ability to develop adequate accounting systems within the timeframe suggested. As a result the operative date will be moved back one year to 30 June 1999. The PSASB considered this would allow:

- jurisdictions at least two full years of preparing accrual reports in accordance with Australian Accounting Standard AAS 29 *Financial Reporting by Government Departments* before needing to apply the standard on Financial Reporting by Governments; and
- sufficient time for the PSASB to conduct a pre-implementation review of the Standard in the light of the experience of the jurisdictions in applying AAS 29.[42]

2.61 Subsequent to this submission, the Chairman of the PSASB, Ian McPhee, advised the Committee of a Heads of Treasuries meeting he attended in September 1995.[43]

2.62 At this meeting concerns were raised about the Standard and its proposed issue date of late 1995 or early 1996. As a result:

> *Heads of Treasuries have asked whether the board would be willing to defer the issue of the standard until mid next year instead of this year so that they may test some of the propositions in the standard and see how the proposed whole of government accounts articulate with other financial reports of government.*[44]

2.63 The result of this meeting was confirmed by the Treasury which indicated that the following were the main issues raised in discussion:

- *the need for further work on conceptual and interpretative issues to clarify the meaning of accrual reports for whole of government;*

42 PSASB, *Submission*, p. S24.

43 Heads of Treasuries is a forum of the Commonwealth, State and Territory departments of Finance and/or Treasury. They meet on an irregular basis.

44 Ian McPhee, PSASB, *Transcript*, p. 120 (Canberra, 4 October 1995).

- *concern that the accounting profession was taking primacy over Parliaments in dictating fiscal reporting standards;*
- *the interpretation of asset valuations in the accounts; and*
- *the desirability of maximising consistency between the ABS [Australian Bureau of Statistics] approach to accrual reporting and that proposed in ED 62.*[45]

2.64 The PSASB subsequently agreed to a revised timetable under which the Standard will be issued by mid-1996 with the implementation date remaining at the financial year beginning 1 July 1998.[46]

2.65 The Australian National Audit Office (ANAO) and Finance have already initiated work on issues associated with the implementation of whole of government reporting.

2.66 The ANAO advised that it had commenced discussions with Finance:

> *... with a view to making a joint submission to the government on the need to commence developing the framework for whole of government reporting. Under this proposal, it is recommended that the two agencies would work together in developing a whole of government reporting model and preparing prototype financial statements for consideration by the Government.*[47]

2.67 Finance advised the Committee that in preparation for the development of a framework for whole of government reporting arrangements:

- Finance and the ANAO had contributed to ED 62 through the Standing Treasury Liaison Committee (STLC) discussion;
- Finance had consulted with the NSW Treasury; and
- Finance and the ANAO had agreed to work together on implementation work.[48]

45 The Treasury, *Submission*, p. S269. For more on ED 62 refer also to the section on Accounting Standards at paras 2.107-2.120.

46 PSASB, *Submission*, p. S305.

47 P J Barrett, Auditor-General, *Submission*, p. S40.

48 Finance, *Submission*, pp. S81-82.

2.68 In addition, Finance provided the Committee with a copy of a paper it prepared for the Heads of Treasuries meeting which addressed a number of issues associated with the development of whole of government reporting.[49]

2.69 Planning for the implementation of whole of government reporting has clearly progressed since the Committee's *Report 338*. Specifically the ANAO has proposed that:

- for 1994-95 financial statements, the ANAO and Finance work together in developing a whole of government reporting model and preparing prototype financial statements;
- for 1995-96 financial statements, the ANAO and Finance prepare trial whole of government reports, testing the framework and processes; and
- after preparing trial 1995-96 financial statements, the ANAO would provide feedback, including interaction with this Committee, on issues requiring further work before an unqualified audit report could be issued and any other issues likely to impact on the successful introduction of whole of government reporting.[50]

2.70 In the ANAO's opinion:

It is only after this process is completed that the Commonwealth would be in a position to make a reasonable estimate of when audited whole of government reports could be produced, and what the costs of producing these reports might be.[51]

2.71 Nevertheless, the ANAO considered it feasible for whole of government reporting to be implemented for the 1997-98 financial year.[52]

49 Finance, *Submission*, pp. S260-67.

50 P J Barrett, Auditor-General, *Submission*, pp. S37-38.

51 P J Barrett, Auditor-General, *Submission*, p. S38.

52 Bill Nelson, ANAO, *Transcript*, p. 54 (Canberra, 8 September 1995).

2.72 Finance also saw merit in trial whole of government reports as it considered that the many interpretative and technical issues, some of which have been previously considered in this report, needed 'to be worked through and resolved before a firm considered position on accrual-based whole of government reporting can be put to government.'[53]

2.73 In the opinion of Finance:

The trial approach would allow for the proper involvement and consideration of the needs of other stakeholders eg the Australian National Audit Office, the Australian Bureau of Statistics, the Treasury and the Parliament through the JCPA. This will also be an important step with respect to the consideration of the integration of the new financial information into the Budget cycle.[54]

2.74 The planning and development work already undertaken by Finance and the ANAO has been constructive and very useful. In particular, the Committee agrees with the proposition that, as a first step, trial whole of government reports should be prepared. This will allow all parties to reflect on the effectiveness of the reporting process and refine the form and content of whole of government reports.

2.75 It is important that the pace of implementation be maintained. For this to happen the profile and level of commitment to whole of government reporting should be elevated. To date the Government has neither established a formal framework, or timetable, for the introduction of whole of government reporting, nor indeed explicitly endorsed the concept. These matters were the subject of recommendations in *Report 338*, to which the Government has not yet responded.

2.76 As stated in *Report 338*, a commitment by the Government to a firm implementation timetable would maintain the momentum of the financial management reform process initiated in the mid-1980s.

53 Finance, *Submission*, p. S82.

54 Finance, *Submission*, p. S83.

2.77 **Recommendation 1**

The Government should commit itself to the preparation of audited whole of government reports beginning with the 1997-98 financial year. To achieve this target the following process and timetable should be adopted:

- ***1994-95 financial statements - the Department of Finance and the Australian National Audit Office to develop a model and prepare exemplar whole of government reports, in consultation with the Joint Committee of Public Accounts;***
- ***1995-96 financial statements - the Department of Finance and the Australian National Audit Office to prepare trial unaudited whole of government reports, the results of which would be referred to the Joint Committee of Public Accounts for review and consideration;***
- ***1996-97 financial statements - the Department of Finance and the Australian National Audit Office to prepare trial unaudited whole of government reports, taking into account modifications to the model deemed necessary, the results of which would be referred to the Joint Committee of Public Accounts for review and consideration; and***
- ***1997-98 financial statements - the Department of Finance and the Australian National Audit Office to prepare audited whole of government reports.***

Legislative framework

2.78 There is provision for the preparation of whole of government reports within the new legislative framework which will replace the *Audit Act 1901*.

2.79 The Financial Management and Accountability Bill 1994 includes clauses which provide for the preparation and audit of annual Statements by the Finance Minister, as required by the regulations.[55]

2.80 As stated in the Explanatory Memorandum accompanying the Bill:

> *The proposed requirement for the form of the statements and the audit certification to be in accordance with the regulations, rather than specified in this Bill, allows the information in the statements to be updated in the light of developments in financial reporting.*[56]

2.81 Whole of government reporting is one such development in financial reporting for which the legislation would allow.

2.82 It was noted during the inquiry that it was 'far from clear at this point'[57] whether or not whole of government reports would replace the Aggregate Financial Statement of the Minister for Finance which is currently prepared annually on a cash basis.[58]

2.83 The question of whether there is a continuing need for cash based Aggregate Financial Statements is one to be considered during the development of whole of government reporting.

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55 Clause 56: Preparation of annual statements by Finance Minister; Clause 57: Audit of Finance Minister's annual financial statements.

56 *Financial Management and Accountability Bill 1994, Explanatory Memorandum*, 1994, p. 15.

57 Dean Wallace, Finance, *Transcript*, p. 175 (Canberra, 20 October 1995).

58 Finance advised that the Aggregate Financial Statement of the Minister for Finance provided an audited statement of receipts and expenditures prepared in accordance with section 50AB of the *Audit Act 1901*, distinguishing the Consolidated Revenue Fund, Trust Fund and Loan Fund. *Submission*, p. S79.

Indicators of financial performance

2.84 The preparation of whole of government reports on an accrual basis will lead to very different financial reports to those which are currently available. The most significant change will be the preparation of a statement of financial position showing the total assets and liabilities of a government. The changed nature of reporting means that new indicators of financial performance will need to be developed.

2.85 The Treasury made the point that analysts need to select the most appropriate measures for evaluating fiscal policy from the range of indicators available. The example was provided of the current budget deficit:

> *... where a range of adjusted deficit measures have been calculated both domestically and overseas in an attempt to assess fiscal policy for different analytical purposes.*[59]

2.86 It appears, however, that much work needs to be done to determine what indicators are most appropriate for Commonwealth whole of government reports. This was acknowledged by Steve Sedgwick, the Secretary of Finance:

> *I am not sure that we have them [a range of performance indicators which might be addressed consistently from year to year] properly at the whole of government level.*[60]

2.87 The range of indicators which were identified in evidence to the Committee included:

- net financial position (net worth);[61]
- change in net worth;[62]
- net worth as a percentage of revenue and Gross Domestic Product (GDP);[63]

59 The Treasury, *Submission*, p. S115.

60 Steve Sedgwick, Finance, *Transcript*, p. 176 (Canberra, 20 October 1995).

61 Finance, *Submission*, p. S76.

62 The Treasury, *Submission*, p. S115.

63 Finance, *Submission*, p. S77.

- debt to revenue;[64] and
- net debt as a percentage of GDP.[65]

2.88 Of all of the conceptual issues in relation to the preparation of whole of government reports, the meaning, relevance and importance of net worth received more comment than any other.

2.89 In whole of government reports net worth is a measure of the net financial position of the government. In the sense that it is the 'bottom line' result it is the accrual accounting equivalent of the budget deficit. It is derived by subtracting total liabilities from total assets and at its crudest level is a measure of the wealth of a government.

2.90 For commercial entities net worth is usually represented by 'net shareholders funds' or 'net equity', which indicates the extent to which the ongoing operations of the entity are supported by equity or by debt.[66]

2.91 The Treasury considered that it is likely that net worth would receive similar attention to the budget deficit, which has been the main focus of fiscal policy debate in the cash reporting environment.[67]

2.92 Dr Graeme Wells, however, submitted that the most important indicator of the financial performance of a government would not be net worth, but instead the ratio of net debt to GDP.[68]

2.93 Both Finance and the Treasury, in fact, raised a number of concerns about placing too much significance on net worth as a 'headline indicator' for the Commonwealth.[69] These views were best expressed by Steve Sedgwick:

64 Finance, *Submission*, p. S83.

65 Dr Graeme Wells, *Submission*, p. S238.

66 Finance, *Submission*, p. S262.

67 The Treasury, *Submission*, p. S114.

68 Dr Graeme Wells, *Submission*, p. S238.

69 Refer to the Treasury, *Submission*, pp. S114-19; Finance, *Submission*, pp. S76-77, S262-65; and Steve Sedgwick, Finance, *Transcript*, pp. 161-63 (Canberra, 20 October 1995).

What worries me a bit about this concept of net worth, as the standards would allow it to be computed, is that it will end up bearing a load that I do not think it is capable of carrying, particularly if you are looking for things like sustainability.[70]

2.94 Mr Sedgwick argued that a more meaningful and clear picture of a government's fiscal outlook and sustainability can be derived from the forward estimates of agencies,[71] which are currently available, although only on a cash basis.

2.95 The Committee acknowledges that it is inappropriate to focus on one indicator alone. A true perspective of a government's financial position can be gained only by reference to a range of indicators.

2.96 The current preoccupation with cash deficit figures is an example of how one indicator can be given undue prominence, often with misleading results.

2.97 It is important that consideration be given to defining and developing the full range of financial performance and position information which can be derived from whole of government reports. No one figure should be given undue emphasis.

2.98 The implementation of whole of government reporting in fact offers an opportunity to inject more balance, and a greater degree of sophistication, in the reporting and debate on the financial performance of governments.

2.99 In this regard, the Committee is aware that Finance and the Treasury are currently preparing a brief on these matters for consideration at the Heads of Treasuries meeting to be held in December 1995.[72]

2.100 These issues should be the subject of wide debate and consultation, so that whole of government reports, once implemented, can be better understood and interpreted.

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70 Steve Sedgwick, Finance, *Transcript*, p. 166 (Canberra, 20 October 1995).

71 Steve Sedgwick, Finance, *Transcript*, p. 166 (Canberra, 20 October 1995).

72 Steve Sedgwick, Finance, *Transcript*, p. 166 (Canberra, 20 October 1995).

2.101 The importance of educating users about the financial indicators which can be derived from whole of government reports cannot be overstated.

2.102 One way of generating public debate and beginning the process of education would be for Finance and/or the Treasury to publish a discussion paper on the financial performance indicators which will flow from whole of government reports.

2.103 This discussion paper could seek public comment on the issues and result in a final report to be considered by the Government and, on behalf of the Parliament, by this Committee.

2.104 **Recommendation 2**

The Treasury and/or the Department of Finance should publish a discussion paper on the financial performance indicators to be derived from Commonwealth whole of government reports. The paper should include discussion of what financial performance indicators may be useful in interpreting such reports, what such indicators mean and how they should be interpreted.

The paper should be distributed for public comment and result in a final report to be considered by the Government and the Joint Committee of Public Accounts, prior to the release of the Accounting Standard on whole of government reporting.

2.105 Another issue in relation to the interpretation of financial information derived from whole of government reports is the impact on the Commonwealth's financial position of transfers to the states. It was argued that the Commonwealth's whole of government reports will be distorted because funds supplied to the States for assets, particularly infrastructure assets, would present a less than accurate picture of the Commonwealth's investment in those assets. Those assets will show in the balance sheet of the States and not that of the Commonwealth.

2.106 Whilst it is true that whole of government reports will not show the full benefits of Commonwealth payments to the States, the Committee considers that these details could be included in interpretive notes accompanying the financial reports.

Accounting standards

2.107 AARF, through the PSASB, has been a strong advocate of the move to whole of government reporting in Australia.

2.108 As part of the development of an accounting standard covering this area, AARF released *Discussion Paper No. 21 - Financial Reporting by Governments*[73] in November 1994. This paper set out the relevant issues to be considered in regard to whole of government reporting and made recommendations for solutions to the issues identified.

2.109 This was followed up, in March 1995, by the publication of ED 62, the draft accounting standard, which was open to public comment.

2.110 Ian McPhee advised that responses to ED 62 were received from eight of the nine Australian jurisdictions with seven of the eight responses being supportive of the proposals in respect of financial reporting by governments. He went on to indicate that a range of technical issues were raised that the PSASB was deliberating on which may result in a change to ED 62 proposals.[74]

2.111 Some of the technical issues brought to the attention of the Committee are discussed later in this chapter.

2.112 As mentioned previously, at a subsequent public hearing Mr McPhee referred to a meeting of the Australian Heads of Treasuries held in September 1995. At this meeting it was proposed to request the PSASB to delay releasing the final standard until 30 June 1996 to enable further consideration of the implications of ED 62.[75]

2.113 The PSASB subsequently agreed to a revised timetable under which the Standard will be issued by mid-1996 with the implementation date remaining at the financial year beginning 1 July 1998.[76]

73 Exhibit No. 18.

74 Ian McPhee, PSASB, *Transcript*, p. 41 (Canberra, 8 September 1995).

75 Ian McPhee, PSASB, *Transcript*, p. 120 (Canberra, 4 October 1995).

76 PSASB, *Submission*, p. S305.

Conclusions

2.114 The significance of the development of an accounting standard incorporating whole of government reporting is recognised by the Committee. It is significant for two reasons.

2.115 First, as expressed by the Auditor General of Western Australia:

> *Uniformity and consistency of reporting between the jurisdictions will be absent if a standard for whole of government reporting is not adopted.*[77]

2.116 The need for consistency across jurisdictions was asserted by the ABS which believes that 'discussion of ... whole of government reporting provides a further opportunity to ensure that appropriate and useful information is provided in a consistent way across all jurisdictions'.[78]

2.117 Finance also made the point that:

> *It is important that there is consistency amongst all Australian jurisdictions as to the policies underpinning the statements so as to allow for a further consolidation at the whole of public sector level if it is considered desirable to do so.*[79]

2.118 Second, the importance of the development of an accounting standard on whole of government reporting is acknowledged with Parliament identified as a major potential user of such reports.

2.119 In the Committee's view, it is therefore important that Parliament be aware, through this Committee, on an ongoing basis of further developments in this regard. This would provide the Committee with the opportunity to comment on matters it deems relevant to assist in Parliament's understanding of this area.

77 D D R Pearson, Auditor General of Western Australia, *Submission*, p. S32.

78 ABS, *Submission*, p. S61.

79 Finance, *Submission*, p. S83.

2.120 The Committee will, therefore, seek to maintain an awareness of the developments in moving to the release of an accounting standard on whole of government reporting so that any implications for the Parliament can be considered in a timely manner.

Technical issues

2.121 A number of submissions received during the inquiry referred to some of the technical issues which need to be addressed prior to the preparation of whole of government reports. The most significant of these issues identified were:

- the boundaries of the government reporting entity;
- how certain entities, notably government business enterprises (GBEs), are to be accounted for within whole of government reports; and
- how assets peculiar to the public sector should be valued.

2.122 Whilst not claiming to possess technical expertise, the Committee has considered these issues from the perspective of potential users of whole of government information.

Boundaries of the government reporting entity

2.123 Defining the boundaries of the government reporting entity is fundamental to preparing whole of government reports. It is this exercise that determines which government agencies, authorities and companies will be included in such reports.

2.124 ED 62 bases the boundaries of the government reporting entity on the notion of 'control',[80] which is defined as:

80 Exhibit No. 17, p. 17.

... the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity.[81]

2.125 The factors indicative of 'control' are:

- *the existence of a Ministerial or other government power which enables the government to give directions to the governing body of that entity on its financial and operating policies;*
- *the government has broad discretion, under existing legislation, to remove a majority of members of the governing body of that entity; or*
- *the government has a majority of the votes that are likely to be cast at a general meeting of that entity.*[82]

2.126 The control test for determining the boundaries of the government reporting entity has had both opponents and supporters.

2.127 Professor Robert Walker, argued that the test of control is 'ambiguous, flawed and inappropriate'.[83] This was based on his review of the early use of whole of government consolidations in Australia and an analysis of the material prepared by the USA's Governmental Accounting Standards Board (GASB) in this area.

2.128 Professor Walker contends that the scope of the financial reporting entity in the public sector standard promulgated by the GASB was more relevant to Australia and had been developed through an extensive process of research and consolidation. The GASB standard referred to tests of 'financial dependence' and 'accountability' rather than a test of control.[84]

81 Exhibit No. 17, p. 44.

82 Exhibit No. 17, p. 18.

83 Professor Robert Walker, *Submission*, p. S151.

84 Professor Robert Walker, *Submission*, p. S156.

2.129 Professor Walker argued that, with a financial dependence and accountability test, a public sector entity which imposes a financial benefit or burden on government must be consolidated. Such a test would therefore require the consolidation of BOOT[85] schemes that are presently 'off-budget'.[86]

2.130 The PSASB responded that the 'fiscal dependency' criterion was not included in ED 62 because it would:

- be beyond any generally accepted notions of accountability in Australia;
- result in criteria for determining the government reporting entity which would be more difficult to interpret than the concept of control;
- require consolidation of private sector businesses which conduct normal arm's-length transactions with a government, specifically where that business relies heavily on those transactions for its profitability; and
- be open to interpretation and possible manipulation, that is, entities could move in and out of the government reporting entity from one year to the next.[87]

2.131 The PSASB also referred to the situation in Canada and New Zealand, claiming that current standards and practice are 'generally consistent with the control criteria in ED 62'.[88]

85 A BOOT (Build, Own, Operate, Transfer) scheme is an arrangement whereby private sector organisations are involved in the financing of public sector infrastructure.

86 Professor Robert Walker, *Transcript*, p. 87 (Sydney, 11 September 1995).

87 PSASB, *Submission*, p. S196.

88 PSASB, *Submission*, p. S196.

2.132 Finance advised the Committee that it had obtained a copy of the GASB standard[89] which refers to fiscal dependence and accountability tests and 'found that it almost meant the same thing'[90] as the control test in ED 62.

2.133 Accordingly, the Committee is not convinced that the problems raised by the PSASB, particularly in regard to the consolidation of private sector businesses, would arise if these tests were followed.

2.134 In the absence of an accounting standard, New South Wales, the Australian jurisdiction most advanced in this area having prepared whole of government reports since 1988, has adopted the control test.[91]

2.135 This was also the practice adopted by Western Australia in the preparation of its unaudited whole of government reports, prepared for the first time in 1995.[92]

2.136 Whilst there was much evidence in support of the control concept, the practical realities of what would be included in the Commonwealth government reporting entity could not be clearly enunciated.

2.137 The view of the PSASB is that all departments, statutory authorities, GBEs and government financial institutions could be consolidated under a control test.[93]

2.138 Examples cited as questionable within the control definition, however, were the Reserve Bank of Australia (RBA) and the universities. The RBA is of particular interest as it is likely that whether or not it was included would have a significant impact on the final result.

89 A copy of the summary of a publication of the GASB on defining the government reporting entity was provided by Finance. Refer to Finance, *Submission*, pp. S303-04.

90 George Carter, Finance, *Transcript*, p. 178 (Canberra, 20 October 1995).

91 *Consolidated Financial Statements of the NSW Public Sector 1993-94*, December 1994, p. 15.

92 Exhibit No. 7, p.7.

93 Ian McPhee, PSASB, *Transcript*, pp. 50-51 (Canberra, 8 September 1995).

2.139 Universities are in a unique position in that they are statutory authorities of the State but are funded directly by the Commonwealth. Even though both jurisdictions use the control test it was noted that universities are not included in the NSW whole of government reports[94] but were included in whole of government reports for Western Australia.[95]

2.140 The problem identified with the organisations above, and potentially others like the High Court and the Australian Broadcasting Corporation, is that 'control' implies the ability to influence day-to-day operations.

2.141 AARF believes, however, that ED 62 has addressed this concern, stating that:

> *... there is control in a financial reporting sense and there is professional independence in getting on with the job at hand - and those two do not necessarily equate.*[96]

2.142 The Committee believes this distinction is important in determining the boundaries of the government reporting entity and is of the view that the ED 62 control definition appears to be applicable in this context.

2.143 For whole of government reporting to be of maximum value to the Government, the Parliament and the community, the Committee believes that all departments, statutory authorities, government companies and government financial institutions should be included in the reporting entity.

2.144 Of the different options considered so far, it seems that the PSASB's concept of control is the most appropriate for the Commonwealth.

2.145 However, before expressing a final view on this issue it would be useful to consider a listing of Commonwealth entities which would fall within the scope of the control test. While the Committee is not suggesting that the reporting entity should actually be defined by reference to a list of

94 *Consolidated Financial Statements of the NSW Public Sector 1993-94*, December 1994, p. 15.

95 Exhibit No. 7, pp. 41-42.

96 Frank Micallef, AARF, *Transcript*, p. 51 (Canberra, 8 September 1995).

agencies, consideration of such a listing would enable a more realistic assessment to be made of the actual scope of the PSASB's proposal.

2.146 As far as the Committee is aware, such a listing has not yet been prepared.

2.147 **Recommendation 3**

The Department of Finance and the Australian National Audit Office should formulate a schedule of all agencies which would come within the ambit of the Commonwealth government reporting entity as defined in the exposure draft Australian Accounting Standard on whole of government reporting.

Further, this schedule should be presented to the Joint Committee of Public Accounts for review prior to the release of the Australian Accounting Standard for whole of government reporting.

2.148 One final issue which arose during the Committee's consideration of the scope of the government reporting entity, was the need to consider and clarify the relationships between:

- the boundaries of government as defined by the ABS for the purposes of the Government Finance Statistics (GFS);[97]
- the boundaries of government as proposed in the Financial Management and Accountability Bill 1994 and the Commonwealth Authorities and Companies Bill 1994;[98] and
- the boundaries of government as proposed in ED 62.

2.149 All three mechanisms describe a government reporting entity and all three do so on a different basis.

2.150 The potential for confusion is readily apparent and it is important that the differences between the three be identified, considered and where necessary reconciled.

97 Exhibit No. 10, pp. 18-24.

98 Refer to the definition of 'Agency' in clause 5 of the Financial Management and Accountability Bill 1994 and the definitions of 'Commonwealth authority' and 'Commonwealth company' in clauses 7 and 34 respectively of the Commonwealth Authorities and Companies Bill 1994.

Combining entities within the government reporting entity

2.151 The method of combining entities within the government reporting entity is another issue which was identified as having a significant impact on the final result. Of particular interest is how GBEs and Public Financial Institutions (PFIs) should be accounted for.

2.152 AARF identified two alternative mechanisms which it regards as appropriate to Australia. They are:

- the full consolidation of all controlled entities; or
- the full consolidation of core government agencies (budget sector agencies) and accounting for the net equity of other entities, such as GBEs.[99]

2.153 With a full consolidation the government's financial statements would be prepared using a line-by-line consolidation of the financial statements of the controlled entities using the purchase method of consolidation.

2.154 Under the purchase method of consolidation, inter-entity transactions and balances are eliminated, therefore ensuring that the financial report of the government reporting entity shows all of the assets controlled, all of the liabilities incurred, and all of the revenues and expenses arising therefrom - whether or not those assets, liabilities, revenues and expenses are controlled through separate operating entities or administrative units.

2.155 Under the alternative method proposed, some controlled entities and transactions are consolidated on a line-by-line basis, while the net equity of some other controlled entities is brought to account on a single line.

2.156 Accounting for the net equity of an entity involves accounting for an investor's share in the ownership interest in an invested entity, that is, recognising the net assets of the entity, adjusting periodically for the government's share in the profits, losses and reserves of those entities.

2.157 Current practice in jurisdictions preparing whole of government reports is varied.

99 Exhibit No. 18, p. 53.

2.158 In New Zealand, Ministers of the Crown, departments, offices of Parliament and the Reserve Bank of New Zealand are combined using the purchase method of consolidation. State-owned enterprises and crown entities are included in the accounts using an equity method of combination.[100]

2.159 This approach was consistent with the opinion of the Finance and Expenditure Committee of the New Zealand Parliament:

> *... which concluded that the cost and impracticability of fully consolidating the financial statements of SOEs [state-owned enterprises] and Crown entities on a line by line basis exceeded any benefits that such fully consolidated financial statements might provide.*[101]

2.160 The Committee understands, however, that the policy for the basis of consolidation in New Zealand is the subject of ongoing review by the Auditor-General and New Zealand Treasury in light of developments in New Zealand and in overseas jurisdictions such as Australia.[102]

2.161 Canada reports its enterprise Crown corporations, which are defined as entities which carry on commercial activities with outside parties and are not financially dependent on parliamentary appropriations, as investments rather than fully consolidating them.[103]

2.162 However, this is understood to be because the move to full accrual reporting for government departments is only now being implemented. As such it was considered practical to only consolidate those entities reporting on a modified accrual basis and report an investment for the commercial entities which are on full accrual accounting.

100 Exhibit No. 5, p. 31.

101 *Report of the Controller and Auditor-General [New Zealand], Third Report for 1995*, October 1995, p. 25.

102 *Report of the Controller and Auditor-General [New Zealand], Third Report for 1995*, October 1995, p. 26.

103 *Annual Financial Report of the Government of Canada Fiscal Year 1993-94*, pp. 18-19.

2.163 In NSW, the 1993-94 Consolidated Financial Statements were prepared on a full consolidation basis except for Law Courts Limited, a joint State/Commonwealth government owned entity, and the State Bank of NSW Limited, which were included on a net equity basis.[104]

2.164 Law Courts Limited was included on a net equity basis in recognition of the State not having control. The State Bank was included on a net equity basis because it was considered that:

> ... *a line-by-line consolidation of financial institutions is not appropriate as the objective of the consolidation is to present the results of operations and the financial status of the State relating mainly to the provision of services via departments and statutory bodies which are classified by the Australian Bureau of Statistics as either general government or public trading enterprises.*[105]

2.165 The *Preliminary Financial Statements for the Government of Western Australia for the year ended 30 June 1994* indicate that all agencies in that jurisdiction were fully consolidated on a line-by-line basis.[106]

2.166 The full consolidation basis is the method proposed by ED 62. The exposure draft goes further, in fact, by explicitly stating that the 'alternative ... is not permitted by this Standard'.[107]

2.167 The reason for this view was intimated by the PSASB as follows:

> *Full consolidation of all entities ensures that the financial reports of governments provide a comprehensive summary of the government's financial position and financial performance, and also ensures that the scope for arbitrary inclusion / non-inclusion of some items is minimised.*[108]

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104 *Consolidated Financial Statements of the NSW Public Sector 1993-94*, December 1994, p. 15.

105 *Consolidated Financial Statements of the NSW Public Sector 1993-94*, December 1994, p. 15.

106 Exhibit No. 7, p. 7.

107 Exhibit No. 17, p.16.

108 PSASB, *Submission*, p. S22.

2.168 The Committee also notes that the ABS has argued that in order for whole of government information to contribute usefully to the preparation of the GFS, entities would need to be fully consolidated.[109]

2.169 The Committee endorses the PSASB's view. The predominant objectives of whole of government reporting presented to and accepted by the Committee were in regard to accountability and decision making purposes.

2.170 That being the case then the Committee considers that all revenues, expenses, assets and liabilities of the government reporting entity should be disclosed in aggregate. Concerns about combining dissimilar activities can be addressed in the presentation of figures, particularly by disclosing sectors separately.

2.171 Matters of presentation are considered separately below.

2.172 The Committee also endorses the following views of the ANAO, as it recognises the need for consistency in applying relevant policies:

> *In the final analysis however, the actual decision on how to include these entities is less important than ensuring that the final policy is clearly disclosed and consistently applied. Inconsistent application of a policy would create a significant risk to the credibility of any whole of government reports.*[110]

2.173 **Recommendation 4**

The Government should ensure that Government Business Enterprises and Public Financial Institutions within the government reporting entity are included on a full consolidation basis in Commonwealth whole of government reports.

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109 Russell Rogers, ABS, *Transcript*, p. 39 (Canberra, 8 September 1995).

110 P J Barrett, Auditor-General, *Submission*, pp. S38-39.

Asset valuation

2.174 One of the key concerns in regard to financial reporting by governments is the approach which should be taken to the valuation of assets, particularly infrastructure and heritage assets.

2.175 Whilst the evidence suggested that it was a contentious issue that was still subject to much debate, the Committee does not believe that the implementation of whole of government reporting should be stalled pending the outcome of that debate.

2.176 In essence there are two issues being debated:

- which assets within the ambit of the government reporting entity should be valued; and
- what basis of valuation should be used.

2.177 The importance of these issues is best illustrated by reference to a situation in NSW. The 1993-94 whole of government reports for NSW did not include a valuation for land under roads on the basis that it did not have any alternative feasible use.[111] This was despite the fact that a valuation was included in the financial statements of the Roads and Traffic Authority.

2.178 The whole of government reports were qualified by the NSW Auditor-General for a number of reasons, one of which was the omission of this valuation.[112]

2.179 In the NSW Auditor-General's opinion, therefore, assets and subsequently net worth were undervalued by $13.8 billion. Given that total equity reported was $63.9 billion the effect of the omission had a significant impact on the final result.

111 *Consolidated Financial Statements of the NSW Public Sector 1993-94*, December 1994, p. 19.

112 *Consolidated Financial Statements of the NSW Public Sector 1993-94*, December 1994, p. 8.

2.180 The general view expressed by representatives of the NSW Treasury is that an asset has a value if there is an opportunity cost. If there is no opportunity cost and an asset is always dedicated to one purpose alone, then there is no merit in placing a value on it.[113]

2.181 This argument was further supported, in regard to heritage assets, by Professor Walker who claimed the process of valuation would be expensive and provide information of little practical benefit to users of whole of government reports. He suggested that heritage assets may be listed with a nominal value placed on them.[114]

2.182 The NSW Auditor-General, Tony Harris, took the opposite view. Noting that the reluctance to value heritage assets in NSW had been on the basis that such assets have no alternative use and/or are difficult to value, he contended that 'Neither basis is seen as an acceptable reason to exempt these assets from valuation.'[115]

2.183 The NSW Auditor-General also contended that assets such as land under roads and the Botanic Gardens in Sydney should be valued at the highest use opportunity cost to the community to determine whether 'the benefit is proximate to the economic value in the asset.'[116]

2.184 The Committee notes that the question of how public sector assets should be valued has been addressed in various forums: - in particular by the Steering Committee on National Performance Monitoring of Government Trading Enterprises in its October 1994 publication *Guidelines on Accounting Policy for Valuation of Assets of Government Trading Enterprises Using Current Valuation Methods*.[117]

2.185 The Committee was also made aware of the development of the so-called 'deprival value' method of valuation, which was endorsed by the above steering committee. The use of this method was criticised, most notably by Professor Walker.

113 NSW Treasury, *Submission*, p. S219.

114 Professor Robert Walker, *Submission*, pp. S161-62.

115 Tony Harris, NSW Auditor-General, *Submission*, p. S68.

116 Tony Harris, NSW Auditor-General, *Transcript*, p. 74 (Sydney, 11 September 1995).

117 Exhibit Nos. 21 and 22.

2.186 The deprival value of an asset has been defined as:

> *... the value to the entity of the future economic benefits that the entity would forego if deprived of the asset. ... Thus the value to the entity in most cases will be measured by the replacement cost of the services or benefits currently embodied in the asset, given that deprival value will normally represent the cost avoided as a result of controlling the asset and that the replacement cost represents the amount of cash necessary to obtain an equivalent or identical asset.*[118]

2.187 Mrs Jenny Morison of Ernst & Young summarised this methodology as follows:

> *... it basically revolves around saying that I make a decision about whether I need that asset. If I was deprived of that asset, would I replace it? If I would replace it, then it [the methodology] takes you through a series of ways that you can value it.*[119]

2.188 Professor Walker's criticism of this methodology is that it involves:

> *... the use of an approach to asset valuation which will not provide a reliable basis upon which to compare the financial circumstances and performance of different agencies.*
>
> *Furthermore, the asset valuations generated by this approach lead to depreciation charges and hence estimates of profit or loss which depart materially from the figures which would have been produced had normal 'private sector' accounting standards been followed.*[120]

118 Exhibit No. 22, p. 9.

119 Jenny Morison, Ernst & Young, *Transcript*, p. 108 (Canberra, 4 October 1995).

120 Professor Robert Walker, *Submission*, p. S160.

2.189 Professor Walker also argued that the deprival value was very similar to the 'current cost accounting' system, a methodology rejected by the private sector in the 1970s, and claimed that 'the introduction of this untried radical method of accounting may ultimately cost many millions of dollars in staff time and fees for minimal, if any, benefits.'[121]

2.190 The deprival value did have support, however, most notably from the accounting firms of Ernst & Young[122] and Coopers & Lybrand.[123] Ernst & Young in particular considered the deprival value to be 'quite robust in providing a reasonable outcome' for infrastructure assets but believed that 'these notions need to be further developed'.[124]

2.191 The PSASB has not endorsed the revaluation of assets because it believes agencies, as in the private sector, can either use historical costs or a reasonable valuation method. However, its position was expressed as follows:

> *... the board has encouraged the use of current values and using deprival value is one way of getting a current value of a particular asset.*
>
> *We have still got to review the implementation experience with the use of deprival value. It may not be perfect, but it is a pretty good framework and I think, quite frankly, it is better information for decision making than historic information which may be 20 or 30 years old. So it is an improvement. It might not be 'the' answer, but it is a long way along the spectrum.*[125]

2.192 In the Commonwealth context, these issues are complicated by the fact that over the last decade Commonwealth agencies have developed their own asset recognition and valuation policies in response to their own circumstances and priorities.

121 Professor Robert Walker, *Transcript*, p. 89 (Sydney, 11 September 1995).

122 Jenny Morison, Ernst & Young, *Transcript*, p. 108 (Canberra, 4 October 1995).

123 Greg Field, Coopers & Lybrand, *Transcript*, p. 118 (Canberra, 4 October 1995).

124 Jenny Morison, Ernst & Young, *Transcript*, pp. 108-09 (Canberra, 4 October 1995).

125 Ian McPhee, PSASB, *Transcript*, p. 128 (Canberra, 4 October 1995).

2.193 As a consequence there is wide divergence across Commonwealth agencies in regard to policies such as capitalisation value, rates of depreciation and whether items such as internally developed software should be 'expensed' or capitalised.

2.194 The Committee recognises that a standard policy across the Commonwealth may not be appropriate. This was noted by the ANAO as follows:

Because of the wide divergence of assets and liabilities within the public sector, it would not be possible, or appropriate, to determine one standard recognition and valuation policy. Accounting standards only require that policies adopted be consistent within a class of assets or liabilities.[126]

2.195 The Committee believes, however, that a framework for asset recognition and valuation policies can and should be developed for the Commonwealth to ensure all agencies deal with these issues in a consistent manner in the future. The development of such a framework could build on the work undertaken by the Steering Committee on National Performance Monitoring of Government Trading Enterprises.

2.196 Debate about the recognition and valuation of assets in the public sector will undoubtedly continue and the Committee is certainly not in a position to recommend the use of one asset valuation methodology over another. Nonetheless, from the Committee's perspective, the following considerations are important:

- where assets are identified as being useful to a government in achieving its objectives and can be reliably measured, they should be recognised and valued, which accords with the Committee's understanding of the ED 62 approach;[127]
- where assets cannot be reliably measured they should be given a notional value and listed in an appendix to whole of government reports;

126 P J Barrett, Auditor-General, *Submission*, p. S40.

127 PSASB, *Submission*, p. S197.

- the methodology ultimately adopted and the reasons for its adoption should be clearly stated in whole of government reports; and
- whatever methodology is adopted should be consistently applied in future years.

2.197 <u>**Recommendation 5**</u>

As a matter of priority, the Department of Finance and the Australian National Audit Office should develop a framework for the recognition and valuation of Commonwealth assets managed by Commonwealth agencies. The purpose of such a framework is to ensure that all Commonwealth agencies develop and use consistent asset recognition and valuation policies. The lack of such a framework in the interim should not be viewed as a barrier to proceeding with whole of government reporting.

In moving to whole of government reporting the Government should ensure that:

- ***only assets that are identified as being useful to a government in achieving its objectives and can be reliably measured, including relevant infrastructure and heritage assets, are recognised and valued;***
- ***where assets cannot be reliably measured they should be given a notional value and listed in an appendix; and***
- ***the methodology ultimately adopted and the reasons for its adoption are clearly stated in whole of government reports.***

Conclusions

2.198 It was heard in evidence that the technical issues 'are not insurmountable and are not the sorts of things that should be preventing progress in this area'.[128]

128 Frank Micallef, AARF, *Transcript*, p. 46 (Canberra, 8 September 1995).

2.199 The Committee agrees with this sentiment. Of primary importance to the Committee is that there is consistency of accounting policies between periods to enable reasonable assessments to be made. The view of the Committee is to put the framework for whole of government reporting in place and address the details later.

Format of whole of government reports

2.200 The actual presentation of information within whole of government reports was another issue considered by the Committee. Whole of government reports, as proposed in ED 62, would include:

- an operating statement (revenues and expenses);
- a statement of financial position (assets and liabilities);
- a statement of cash flows; and
- notes to the financial statements showing disaggregated information and information about items such as restricted financial assets and capital expenditure commitments among other items.[129]

2.201 The display of the information within this setting, however, was raised as a topic requiring consideration. The options put forward included presentation by:

- institutional sectors (General Government, Public Trading Enterprises and Public Financial Enterprises), in accordance with the GFS presentation;[130]
- functional classification (for example health, defence etc.); [131]

129 Exhibit No. 17, pp. 22 & 32-39.

130 ABS, *Submission*, p. S63. The Government Finance Statistics are developed on the basis of standards prescribed by the International Monetary Fund. These standards currently endorse the use of cash accounting concepts and include splitting the statistics for the economy into institutional sectors. For a paper on the concepts associated with GFS refer to Exhibit No. 10.

131 Finance, *Submission*, p. S83.

- economic classification (for example salaries and wages, administration costs, depreciation etc.);[132] or
- tabular form showing line items of revenues and expenditure by functional classification.[133]

2.202 The GFS requires further explanation. Through its GFS program the ABS 'provides a comprehensive statistical picture of the financial performance of Commonwealth, State and local governments'.[134]

2.203 The ABS advised the Committee that in 1991 the Commonwealth and States had agreed on uniform presentation arrangements of budget documents in accordance with the GFS standard concepts and classifications, which has enabled the activities of all governments to be compared in a consistent way, since that time.

2.204 The ABS also advised that in line with other developments leading to an increased demand for the presentation of government financial data on an accruals basis, an exposure draft containing a proposal to adapt GFS to a predominantly accruals basis had been released.[135]

2.205 The ABS advised the Committee that it was likely

> *... that by the turn of the century the IMF [International Monetary Fund] will certainly be expecting accrual government finance statistics from the statistically advanced countries.*[136]

2.206 Accordingly, the ABS was very clear about its preferred option of display:

> *... for us to be able to use the information it would be crucial to have that institutional sector split. A whole of government, totally consolidated set of numbers would not be all that helpful to us, even if they were on an accruals basis. That is*

132 Finance, *Submission*, p. S83.

133 Professor Robert Walker, *Submission*, p. S164.

134 ABS, *Submission*, p. S61.

135 Dr Richard Madden, ABS, *Transcript*, pp. 32-33 (Canberra, 8 September 1995). A copy of the Exposure Draft was provided in the course of the inquiry as Exhibit No. 9.

136 Dr Richard Madden, ABS, *Transcript*, p. 32 (Canberra, 8 September 1995).

because, for our presentations - in terms of economic transactions by institutional sector, by jurisdiction - we would have to get below that level.[137]

2.207 In Western Australia, the 1993-94 unaudited whole of government reports included an appendix showing disaggregated information in accordance with the ABS proposal.[138]

2.208 In New South Wales, however, the split in its 1993-94 audited financial statements was between the budget and non-budget sectors.[139] The disaggregation in accordance with the GFS sectors was included as part of unaudited supplementary information.[140]

2.209 The need for uniformity among all jurisdictions was recognised by the Committee, especially given the likely move of the ABS to adopting accrual principles for GFS. Accordingly, the Committee believes the Commonwealth Government should take a leading role and seek a commitment from all State and Territory governments to move to whole of government reports presented by institutional sector.

2.210 **Recommendation 6**

Commonwealth whole of government reports should be presented in a form consistent with the format specified by the Australian Bureau of Statistics for the Government Finance Statistics.

The Commonwealth Government should seek a commitment from all State and Territory governments for the implementation, in accordance with an agreed timetable, for the preparation of whole of government reports, through the Council of Australian Governments forum.

137 Frederick von Reibnitz, ABS, *Transcript*, p. 34 (Canberra, 8 September 1995).

138 Exhibit No. 7, pp. 35-40.

139 Refer to *Public Accounts of the NSW Budget Sector 1993-94*, November 1994, pp. 14-36 for the Budget Sector and *Consolidated Financial Statements of the NSW Public Sector 1993-94*, December 1994, pp. 37-39 for the Non Budget Sector information.

140 *Consolidated Financial Statements of the NSW Public Sector 1993-94*, December 1994, p. 44.

As part of the commitment it should be agreed that consistent policies and presentation, determined in the Heads of Treasuries forum, will be adopted and applied, as far as is practicable, by all parties.

2.211 With regard to further disclosure in whole of government reports, the Committee considers there is merit in the preparation in a tabular form of line-by-line items by functional classification. The cost of preparing such information, however, requires consideration.

2.212 An analysis of the costs of obtaining, collating and auditing such information should be undertaken by Finance and the ANAO, in consultation with this Committee, as part of preparatory work they perform in the years leading up to preparing audited whole of government reports.

2.213 The view of the Committee is that while the cost of setting up systems to enable a tabular presentation of information may be significant in the first year, the benefit of being able to more easily track expenditure trends over time, would probably justify any additional cost.

2.214 **Recommendation 7**

The Department of Finance and the Australian National Audit Office should analyse, in consultation with the Joint Committee of Public Accounts, the likely costs of obtaining, collating and auditing the information necessary to prepare a note within whole of government reports showing line items of expenditure by functional classification.

2.215 In addition, the Committee considers a readers aid to the statements, including a commentary on the results should be prepared. The responsibility for preparing such a commentary would rest with Finance.

2.216 **Recommendation 8**

The Department of Finance should review what commentary and other information could be included in a readers aid attached to whole of government reports in consultation with the Joint Committee of Public Accounts.

Consistent application

2.217 The importance of applying policies and procedures and presenting whole of government reports consistently from one period to the next cannot be overstated. The capacity to analyse trends over time is one of the most important aspects of whole of government reporting. The validity of such analysis would be undermined if, for example, universities or Statutory Marketing Authorities were included in the government reporting entity one year and excluded the next.

2.218 The responsibility for ensuring consistent application of policies, procedures and presentation of information rests with Finance.

2.219 Recommendation 9

The Department of Finance should ensure that the content and format of whole of government reports for the Commonwealth remain consistent over time to allow for meaningful year to year comparisons.

In particular, consistency should be ensured for:

- *the composition of the Commonwealth government reporting entity;*
- *the method of combining entities within the Commonwealth government reporting entity;*
- *the methodology for the recognition and valuation of assets; and*
- *the presentation and display of information within Commonwealth whole of government reports.*

Regularity of reporting

2.220 In *Report 338* the Committee proposed that whole of government reports should be prepared at least annually.[141] This is consistent with the approach contemplated in ED 62.[142]

2.221 During the course of the whole of government reporting inquiry there was widespread agreement that annual reporting was an appropriate short term objective for the Commonwealth. There was less consensus on whether the Commonwealth should set the goal of reporting on a more frequent basis at some point in the future. There were two options suggested in terms of more frequent reporting. They were:

- the presentation of reports every six months in the long term;[143] or
- the presentation of reports every six months in the medium term and on a quarterly basis in the long term.[144]

2.222 An example of even more frequent reporting can be found in New Zealand where whole of government reports are prepared on a monthly basis, six weeks after the end of the month.[145]

2.223 The ANAO stated that the regularity of reporting 'depends entirely upon what the resulting information is to be used for' and that it would seem unlikely that more frequent

141 *Report 338*, p. 86.

142 Exhibit No. 17, p. 40.

143 D D R Pearson, Auditor General of Western Australia, *Submission*, p. S32; Ernst & Young, *Submission*, p. S179.

144 Coopers & Lybrand, *Submission*, p. S148.

145 Ian McPhee and Frank Micallef, PSASB, *Transcript*, p. 43 (Canberra, 8 September 1995). The task of preparing whole of government reports is somewhat easier in New Zealand as State-owned enterprises are not fully consolidated. See Lynne O'Brien, ANAO, *Transcript*, p. 56 (Canberra, 8 September 1995).

reporting than annually would be necessary if whole of government reports are to be used only to satisfy accountability requirements.[146]

2.224 This view was shared by Finance who stated:

Ultimately the frequency of preparation of the reports will be determined by the benefits of the reports compared to the cost of preparing them. This is unclear at this stage and it would be prudent to suspend judgement until the facts have been better established.[147]

2.225 On the other hand, the practice in the private sector[148] was raised with the Committee by Brian Kimball from Ernst & Young:

... you might want to think more towards what happens at a corporate level in the private sector, which is six monthly reporting and perhaps on a slightly less rigorous basis, but enough to give a fairly good benchmark on progress through the year for the total view of government.[149]

2.226 The Committee is inclined to the view that the preparation of whole of government reports every six months would provide a useful mid-year snapshot of a government's financial position and performance.

2.227 Six monthly reports would allow trends to be better examined, as well as showing in a timely fashion the financial effect of major government decisions.

2.228 The question of whether to report on a more frequent basis than every six months is best reserved until some point in the future, when the costs and benefits may emerge more clearly.

146 P J Barrett, Auditor-General, *Submission*, p. S41.

147 Finance, *Submission*, p. S252.

148 The listing rules of the Australian Stock Exchange require listed corporations to prepare half yearly financial reports within 75 days of the end of the period. The format, specified by the listing rules is not as detailed as for annual reports. The half yearly reports are subject to review by auditors, but not a full and complete audit as for the annual accounts.

149 Brian Kimball, Ernst & Young, *Transcript*, p. 107 (Canberra, 4 October 1995).

2.229 **Recommendation 10**

As well as supporting the preparation of annual audited whole of government reports by 1997-98, the Government should commit itself to the preparation of unaudited six monthly whole of government reports by 1999-2000.

Role of Parliament

2.230 The role of parliament in considering whole of government reports and the accounting policies on which they are based, came to light in evidence presented in relation to the NSW experience.

2.231 Although audited whole of government reports have been prepared and published by successive NSW governments since 1988, they have not been tabled in the NSW Parliament.

2.232 As explained by the NSW Auditor-General, Tony Harris, this means that they have never been given parliamentary consideration or scrutiny.[150]

2.233 Tony Harris considers whole of government reports to be 'the pre-eminent documentation that the state can produce'.[151] Drawing on the experience in NSW, Mr Harris argued that:

... the JCPA should be involved in determining the principles on which they [that is, the Commonwealth's whole of government reports] are formed, it should require them to be audited by the parliament's auditor and it should require them to be tabled.[152]

150 Tony Harris, NSW Auditor-General, *Transcript*, p. 66 (Sydney, 11 September 1995).

151 Tony Harris, NSW Auditor-General, *Transcript*, p. 66 (Sydney, 11 September 1995).

152 Tony Harris, NSW Auditor-General, *Transcript*, p. 72 (Sydney, 11 September 1995).

2.234 Tony Harris also made reference to the audit report for the 1993-94 NSW whole of government reports where there were six qualifications.[153] It was stated:

I think the JCPA should take a real interest in the differences between the auditor and the government about the financial statements.[154]

2.235 Subsequent to their tabling in Parliament, therefore, whole of government reports should be reviewed by a parliamentary committee with particular emphasis on examining the consequences of the reports and any differences between the auditor and the government.

2.236 Tony Harris explained further as follows:

I used the word 'examine'. I hesitate to use the word 'adjudicate', but with the problems we have in New South Wales we have certain intractable differences between us [Treasury and the Auditor-General] ... but you [a parliamentary committee] could probably throw some light on the differences and give some comfort to the fact that the differences are soundly based and are not ephemeral or not a sign of obstinacy.[155]

2.237 The notion of a parliamentary committee having a role after tabling was supported by the Auditor-General of Western Australia:

Parliamentary Committees should have a role in reviewing whole of government information, but not as intensive as reviewing the detailed information prepared by individual public sector agencies.[156]

2.238 The Committee considers that parliamentary committee review of whole of government reports would be an important means of analysing the information presented. It would also provide a forum for differences in opinion between

153 *Consolidated Financial Statements of the NSW Public Sector 1993-94*, December 1994, pp. 8-10.

154 Tony Harris, NSW Auditor-General, *Transcript*, p. 73 (Sydney, 11 September 1995).

155 Tony Harris, NSW Auditor-General, *Transcript*, pp. 81-82 (Sydney, 11 September 1995).

156 D D R Pearson, Auditor General of Western Australia, *Submission*, p. S31.

the preparers of the reports and the Auditor-General to be examined. By publicly examining any differences of opinion or interpretation it may be possible to resolve them before preparing reports for the following year.

2.239 This is a responsibility which falls squarely within the charter of the Joint Committee of Public Accounts. The *Public Accounts Committee Act 1951* specifies various duties for the Committee, including:

(a) *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;*

(aa) *to examine the financial affairs of authorities of the Commonwealth to which this Act applies and of inter-governmental bodies to which this Act applies;* ...

(b) *to 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;*

(c) *to 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. ...*[157]

2.240 **Recommendation 11**

The Government should ensure that audited whole of government reports are tabled in Parliament within a reasonable time after the end of the financial year and that they stand referred to the Joint Committee of Public Accounts for review.

157 Sub-section 8(1), *Public Accounts Committee Act 1951*.

Further review by the Committee

2.241 As stated in *Report 338*, 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.

2.242 Although there are a number of policy and technical issues which are still the subject of debate, these should not be seen as an impediment to the implementation of whole of government reporting.

2.243 In fact, the Committee believes that establishing whole of government reporting will provide significant stimulus for the resolution of these issues, some of which have been problem areas for the public sector for some considerable time, for example asset valuation.

2.244 In light of this the Committee encourages the Government to recognise the potential benefits of whole of government reporting and support the establishment of a framework for its implementation by 1997-98.

2.245 The Committee intends to maintain an active interest in the development of whole of government reporting and, as discussed earlier in this chapter, looks forward to being consulted as significant issues emerge over the next few years. The Committee will periodically review progress in the implementation of whole of government reporting and as appropriate report matters of note to the Parliament.

3

FISCAL RESPONSIBILITY LEGISLATION

Chapter outline

3.1 This chapter constitutes the Committee's report on its Terms of Reference into fiscal responsibility legislation.

3.2 The chapter is set out in the following sections:

- **What is fiscal responsibility legislation?**

  This section discusses the underlying principles of fiscal responsibility legislation.

- **Models of fiscal responsibility legislation**

  This section examines models of fiscal responsibility legislation operating in other countries, with particular attention to two contrasting approaches, namely:

  - the **United States of America** - where fiscal targets are set and enforced; and
  - **New Zealand** - where fiscal discipline is imposed principally through strict fiscal reporting requirements.

- **Why legislate for fiscal reporting?**

  This section questions whether or not it would be desirable to specify fiscal reporting requirements in legislation.

- **Criticisms of fiscal responsibility legislation**

  The Committee addresses criticisms of fiscal responsibility legislation made in evidence to the inquiry.

- **Desirable features of fiscal reporting legislation for the Commonwealth**

  This section contains the Committee's conclusions and recommendations on its Terms of Reference.

What is fiscal responsibility legislation?

3.3 Fiscal responsibility legislation is a very new development in the field of public finance. For this reason, there is considerable uncertainty about what fiscal responsibility legislation is in principle and in practice.

3.4 It would be useful at the outset to dispel some of the more common misconceptions about fiscal responsibility legislation. First, fiscal responsibility legislation does **not** necessarily mean setting mandatory fiscal targets - such as a requirement to balance the budget - with legal remedies invoked against governments that fail to achieve those targets. Second, fiscal responsibility legislation neither requires the definition of what is prudent or proper fiscal policy as opposed to irresponsible or reckless fiscal policy, nor requires governments to bring down budgets according to a pre-set fiscal formula.

3.5 Rather, fiscal responsibility legislation provides a statutory **framework** for successive governments to be accountable to the public for the discretionary fiscal policies they have chosen to implement.

3.6 As the Auditor-General suggested:

Fiscal responsibility could more accurately be defined as the government taking decisions and being held accountable for the outcomes of these decisions. The critical factors, therefore, are to ensure that the government has available to it credible information upon which to make informed decisions about the necessary balances between its objectives and to ensure that the Parliament, and the public, has available to it information on which to judge the outcome of these decisions.[1]

3.7 Fiscal responsibility legislation emphasises fiscal reporting - not fiscal targets - as the means to discipline fiscal policy.

Fiscal responsibility legislation and accrual accounting

3.8 Fiscal responsibility legislation can be seen as the third stage in the evolution of accrual based accounting and reporting systems to replace cash based accounting and reporting systems for the Commonwealth.

3.9 The **first** stage in the transition from cash to accrual accounting was the introduction of accrual accounting and reporting within individual agencies.

3.10 The **second** stage will be the preparation of consolidated accrual accounts for the public sector in the form of whole of government reports.

3.11 The **third** stage will be the development of a fiscal policy framework designed to exploit the capability of accrual based whole of government reports.

3.12 The full potential of accrual based accounting and whole of government reporting will not be realised unless there is also a mechanism for this information to feed into the government's fiscal decision making process.

3.13 The Committee sees fiscal responsibility legislation as a mechanism for feeding accrual information into the budget cycle.

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1 P J Barrett, Auditor-General, *Submission*, p. S34.

3.14 It is thus no accident that the Committee's inquiry into fiscal responsibility legislation for the Commonwealth follows closely on its inquiries into accrual accounting and reporting for the Commonwealth[2] and whole of government reporting for the Commonwealth[3].

Cash based reporting and budgeting vs accrual reporting and budgeting

3.15 Before the Committee examines models of fiscal responsibility legislation for the Commonwealth, it is important for there to be a clear understanding of the form that future Commonwealth financial reporting is likely to take - cash or accrual. Models of fiscal responsibility legislation in cash and accrual accounting environments are markedly different.

3.16 The Committee has strongly advocated the move to an accrual culture for the Commonwealth.

3.17 However, the Department of Finance (Finance)[4] and the Treasury[5], the two key financial reporting departments for the Commonwealth, are still hesitant about embracing accrual reporting and budgeting for the Commonwealth as a whole.

2 Joint Committee of Public Accounts, *Report 338 Accrual Accounting - A Cultural Change* (AGPS, August 1995).

3 The Committee's conclusions and recommendations on the implementation of whole of government reporting for the Commonwealth appear in Chapter 2 of this report.

4 Steve Sedgwick, Secretary of the Department of Finance, did not oppose the move to whole of government reporting, but cautioned against 'fadism'. *Transcript*, pp. 167-70 (Canberra, 20 October 1995). Mr Sedgwick called for careful examination and interpretation of accrual aggregates such as net worth before '... we launch them onto an unsuspecting public and get a lot of unfocused and unproductive argument about what the numbers actually mean'. *Transcript*, p. 168 (Canberra, 20 October 1995).

5 The Treasury had not decided how it might use whole of government reports, preferring to wait and see what new information the reports offered. It was anticipated that accrual based whole of government reports could be useful for medium term fiscal policy analysis. *Submission*, pp. S188 & 272-73. The Treasury appeared to have given little consideration to accrual budgeting. Bruce Taplin, *Transcript*, p. 141 (Canberra, 4 October 1995) and the Treasury, *Submission*, p. S272.

3.18 So it might be useful at this stage to compare the Commonwealth's present system of financial reporting with what would be proposed under accrual based whole of government reporting for the Commonwealth.

3.19 Inter alia, this analysis will allow some assessment of which system of reporting and budgeting - cash or accrual - would be superior in terms of allowing the parliament and the public to monitor the fiscal performance of governments.

Existing cash based system of financial reporting for the Commonwealth

3.20 At present, there are four distinct cycles of financial reporting for the Commonwealth. One cycle focuses on **accounting for money spent** in the last financial year. Finance consolidates financial data from core budget sector[6] government agencies to give an overall picture of receipts and expenditures, published in November or December each year as the Aggregate Financial Statement of the Minister for Finance. Monthly cash flow statements for the Commonwealth budget sector are published as the Commonwealth Government Statement of Financial Transactions (CFT) series.

3.21 There is a legislative framework underpinning the accountability cycle - currently described in the *Audit Act 1901*, which is proposed to be replaced by the Financial Management and Accountability Bill 1994, the *Commonwealth Authorities and Corporations Bill 1994* and the Auditor-General's Bill 1994.[7]

3.22 The second cycle of reporting is the budget cycle. The principal purpose of this series of financial statements is to **track and forecast trends in government revenue and outlays and to indicate the impact of fiscal policy**. The key reports for this cycle are the Budget Papers themselves and the Final Budget Outcome - reconciling actual revenue and outlays with estimates.

6 The budget sector includes all government agencies funded from the Consolidated Revenue Fund.

7 At the time of writing these Bills were before the Senate.

3.23 There is no legislative requirement for the tabling of the budget cycle reports; the content of the Budget Papers is the prerogative of the government of the day.[8]

3.24 The Budget Papers include:

- the **Budget Speech** - in which the Treasurer outlines the government's policy initiatives and fiscal strategy for the coming financial year.
- **Budget Paper No. 1** - which contains statements on:
  - the Australian economy and key economic indicators;
  - **forecast budget outlays** for the next three years;
  - **revenue estimates** for the next three years;
  - Commonwealth budget financing and debt management strategy;
  - the public sector (including trading enterprises) based on data from the Australian Bureau of Statistics (ABS); and
  - Commonwealth statistics and budget concepts.
- **Budget Paper No. 2** - which contains the Commonwealth Public Account for the coming financial year and the Appropriation Bills. This is based on estimates by government agencies of their running costs and other expenses for the coming financial year.
- **Budget Paper No. 3** - which details the Commonwealth's financial relations with other levels of government for the coming financial year.

3.25 The *third* cycle of financial reporting revolves around the Premiers' Conference and the Loan Council meetings. The report, *National Fiscal Outlook*, prepared for the Premiers' Conference each year, forecasts the financial position of the nation as a whole - taking into account the fiscal strategies and levels of debt of the Commonwealth, the States and the Territories. The Loan Council documents give an overview of Australia's call on financial markets for the non-financial public sector (Commonwealth, States and Territories).

8 Bruce Taplin, the Treasury, *Transcript*, p. 135 (Canberra, 4 October 1995). The Treasury, *Submission*, p. S280.

3.26 The final cycle of financial reporting is that of the ABS - which prepares the Government Finance Statistics for the Commonwealth and the States in accordance with internationally agreed reporting standards. ABS statistics include government trading enterprises - not just the budget sector.[9]

3.27 Financial reporting for the Commonwealth is now basically on a cash basis - although the ABS has published an Exposure Draft outlining plans to move the Government Finance Statistics onto an accrual basis.[10]

3.28 The advantages of the presentation of government accounts on a cash basis are that it is simple and that the bottom line measure - the budget deficit or surplus - captures the net short term impact of the budget.[11] That is, cash based accounts - which combine current and capital accounts - clearly reveal the fiscal stimulus or fiscal tightening achieved by running a budget deficit or budget surplus respectively.[12]

9 Exhibit No. 10.

10 Exhibit No. 9.

11 Finance, *Submission*, p. S80.

12 However, the NSW Auditor-General suggested that the cash based budget reports did not accurately quantify the macroeconomic impact of fiscal policies. Distortions were introduced:

- *by including sales of assets as deficit reducing actions, when their macro-economic effects often are far smaller than their effects on the deficit;*
- *by distinguishing between the budget and the non-budget sectors such that transactions between the two sectors can appear to have macro-economic effects when there is none;*
- *by excluding from the calculations unrecorded borrowings (either from the future or from the present generation) such as growth in unfunded superannuation expenses.*

Tony Harris, NSW Auditor-General, *Submission*, p. S67.

3.29 Cash aggregates such as the budget deficit or surplus, having been the subject of interpretation and debate over time, are also fairly well understood by practitioners and commentators alike.[13]

Monitoring fiscal responsibility in a cash culture

3.30 It can be seen from the type of information provided in the Budget Statements that the focus of fiscal policy for the Commonwealth in a cash culture has to be on revenue and outlays. The present 'headline' indicator of the Commonwealth's financial performance is the cash deficit or surplus which is very simply derived by subtracting total outlays from total revenue.[14]

3.31 In the cash based Budget Papers, the budget convention is to show government spending as 'outlays', asset sales as 'negative outlays' and money received by the government during the year as 'revenue'.[15]

3.32 If the Commonwealth continues in a cash based environment, then financial planning for the Commonwealth will continue to focus on cash indicators - including the cash deficit or surplus.

3.33 It was put to the Committee that the budget deficit/surplus and other cash indicators are poor measures of financial performance[16] and not sensible fiscal policy targets.[17]

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13 Steve Sedgwick, Finance, *Transcript*, p. 164 (Canberra, 20 October 1995).

14 Commonwealth of Australia, *Budget Statements 1995-96*, Budget Paper No. 1, Budget Statement No. 7.

15 *Budget Statements 1995*-96, Budget Statement No. 7.

16 For example, Dr Louise Kloot, Senior Lecturer in Accounting at Swinburne University of Technology, considered the cash deficit 'has no inherent meaning'. *Submission*, p. S4.

17 John Quiggan, Department of Economics, James Cook University, *Submission*, p. S134.

3.34 In any case, the cash deficit/surplus was argued to be 'too open to manipulation to allow for its use in any "fiscal responsibility" legislation'.[18] This, and other criticisms of cash based reporting are developed below.

Criticisms of cash based reporting for the Commonwealth

3.35 The evidence to this inquiry revealed general dissatisfaction with the present cash based system of financial reporting in Australia, and in particular, concern about its usefulness for monitoring and promoting fiscal responsibility.

3.36 The major - and fundamental - criticisms were as follows:

- *that the cash accounting basis of fiscal reports does* not disclose the long term fiscal impact of current decisions;
- that no distinction is made between the current and capital accounts, permitting the government to manipulate the budget deficit - for example, by asset sales;[19] and
- that costs can be shifted 'off-budget' to other levels of government or to the private sector.[20]

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18 Ian McAuley, Faculty of Management, University of Canberra, *Submission*, p. S48.

19 Ian McAuley, *Submission*, p. S46. Professor Marc Robinson, Queensland University of Technology, *Submission*, pp. S57-60. John Quiggan, *Submission*, pp. S137-38.

20 Ian McAuley, *Submission*, p. S47. John Quiggan, *Submission*, p. S134.

3.37 The ABS, itself moving to an accrual culture, submitted that there was an **increased demand for the presentation of government financial data on an accrual basis**, including at the international level. Dissatisfaction with cash based statistics stemmed in part from:

(i) *A general acceptance that cash based statistics do not present a full picture of government finances. This particularly relates to issues such as unfunded superannuation liabilities and accounting for infrastructure, where there is a widely held view that accrual based statistics give a better overall view. This general dissatisfaction with cash based statistics also includes an increased recognition of the distorting effect of including in the statistics cash flows associated with major asset sales. ...*

(iii) *An increased need for additional, more appropriate statistical tools to facilitate comparison of the State and Federal Governments' performance in managing their financial affairs. The deficit/surplus measure has a number of deficiencies which severely affect its usefulness in this context.*

(iv) *A requirement within the ABS for the general government sector components of the Australian National Accounts to be recorded on an accruals basis. The use of cash based data introduces non-seasonal distortions to many series ... which have undesirable consequences when producing seasonally adjusted estimates. ...*[21]

3.38 The ABS considered that 'the implementation of accrual based financial accounts will be an important step towards improving the usefulness of information that governments provide'.[22]

21 ABS, *Submission*, pp. S61-62.

22 ABS, *Submission*, p. S62.

Monitoring fiscal responsibility in an accrual culture

3.39 If whole of government reporting on an accrual basis were to be introduced, the following financial information would be published for the Commonwealth:

- operating statement;
- statement of financial position; and
- statement of cash flows.

3.40 The **operating statement** shows revenues and expenses, broken down by type. That is, revenues are broken down into taxation, regulatory fees, investment income, sale of goods and services, sale of capital items and so on. Expenses are broken down into salaries and wages, interest and other finance costs, grants and transfers and so on. It is, of course, also possible to do a breakdown by functional classification, where expenses could be shown as allocated to a particular set of programs - health, social security, defence and so on. The operating statement yields an operating balance (surplus or deficit) for the year - indicating whether the cost of government activities for the period has been recovered from revenues or whether a financing requirement has arisen.

3.41 The **statement of financial position** records the assets, liabilities and the resulting 'net worth' of a government. This statement will show, over time, the impact of asset sales, government investment, changes in the value of government assets, and so on.

3.42 The **statement of cash flows** breaks down total Commonwealth cash flows into cash flows from operating activities, cash flows from investing activities and cash flows from financing activities. This statement provides a basis for assessments of future cash needs.[23]

23 Public Sector Accounting Standards Board (PSASB), *Submission*, p. S193.

3.43 All of this information replaces the revenue/outlays report produced in a cash culture. The 'new' information now available to assess the government's fiscal performance includes:

- a clear picture of whether the government is running down its asset base, selling assets to fund an operating deficit, or building up the asset base through productive investment;
- disclosure of accruing liabilities such as superannuation; and
- the indication of long term fiscal strength (the ratio of net debt to net worth).

3.44 Mr Michael Lambert, Secretary of the New South Wales (NSW) Treasury - which has published whole of government reports on an accrual basis for a number of years - explained to the Committee that whole of government reporting has a number of benefits, namely:

> *It [whole of government reporting] focuses the policy attention on financial position, not just cash flows and not just debt, but the whole balance sheet. Therefore, the thing we keep stressing is that a policy like privatisation is put into [proper] context. Privatisation, in our view, should always be considered in terms of its economic impact.*
>
> *There is a tendency to look at it [privatisation] in terms of its financial impact as a way of improving your financial position. We say that this is not quite right, because what you are doing is that you are converting an equity on your balance sheet into cash on your balance sheet, which may then be converted into reduction of debt. You are restructuring your balance sheet, and you should not use that as a means to justify privatisation. Privatisation may or may not have justification, but not in terms of financial position per se. It [whole of government reporting] does provide, as I said, a broader framework to look at your financial position.*[24]

3.45 The Committee agrees that accrual based whole of government reports provide a broader view of the financial performance of government and a better framework for fiscal decision making.

24 NSW Treasury, *Submission*, p. S217.

3.46 Finance and the Treasury raised some concerns about the use of Commonwealth whole of government reports as a tool for monitoring fiscal responsibility.

3.47 Potential problems identified were:

- that whole of government reports for t. Commonwealth would not include State assets funded by the Commonwealth;[25]
- that whole of government reporting could focus an undue level of attention on the Commonwealth's net worth and thus tend to distort Commonwealth spending into asset accumulation;[26]
- that it had not been proven that whole of government reports were a useful financial diagnostic and that accrual aggregates, such as net worth, were not well understood.[27]

3.48 The Committee took the Departments' concerns seriously and these, and other, criticisms of fiscal responsibility legislation are addressed, one by one, later in this chapter.

Accrual budgeting for the Commonwealth

3.49 If the Commonwealth is to move to accrual accounting and reporting, a 'necessary inference', according to the NSW Auditor-General, is that budgeting would also be undertaken on an accrual basis.[28]

25 The Treasury, *Submission*, p. S117. Finance, *Submission*, p. S262.

26 Steve Sedgwick, Finance, *Transcript*, p. 177, (Canberra, 20 October 1995).

27 Steve Sedgwick, Finance, *Transcript*, pp. 161 & 169-70 (Canberra, 20 October 1995).

28 Tony Harris, Auditor-General of NSW, *Submission*, p. S67. See also Iain Summers, Auditor-General for the Northern Territory, *Submission*, p. S10.

3.50 It would be dysfunctional for Commonwealth agencies fully to embrace accrual based accounting principles while being forced to budget and appropriate funds in a cash accounting environment.[29]

3.51 The Treasury submitted that accrual budgeting was not necessarily a natural progression from accrual reporting, noting however that

> ... *if fiscal objectives are linked to accrual-based measures of performance and financial position, budgeting on the same basis could assist in achieving those objectives. A move to accrual budgeting will largely depend on the acceptance by parliaments and the wider community of the accrual perspective on government financial operations.*[30]

3.52 It was made clear to the Committee that there are no present plans to move the Commonwealth budget cycle reporting onto an accrual basis. The Treasury appeared to have given no serious consideration to the implications of accrual accounting and whole of government reporting for the budget process.[31]

29 Mrs Jenny Morison, Senior Manager, Ernst & Young, stressed this point from the perspective of a private sector accountant advising government departments on their year-end financial reports:

> *We need to drive [accrual accounting and reporting] with accrual budgeting as much as anything because we are still sending quite a confusing message to managers in that they are reporting in this accrual framework, but in the end we are still going to give them a cash budget and ultimately that is where their performance will be generally assessed.*

Transcript, p. 104 (Canberra, 4 October 1995).

30 The Treasury, *Submission*, p. S272.

31 The Treasury, *Submission*, p. S272 , Bruce Taplin, the Treasury, *Transcript*, pp. 140-41 (Canberra, 4 October 1995).

3.53 Mr Steve Sedgwick, Secretary of the Department of Finance, informed the Committee that the proposed whole of government reports for the Commonwealth would not feed into the budget process at all - firstly because the budget is cash based, but also because whole of government reports will only be finalised at the end of the calendar year after the budget is all over.[32]

3.54 At this stage, it is not even intended that the forward estimates will be prepared on an accrual basis.[33]

3.55 Mr Sedgwick did not consider the preparation of accrual estimates to be useful when appropriations would continue on a cash basis. Mr Sedgwick correctly pointed out that the Commonwealth is not going to give agencies millions of dollars every year to fund depreciation charges, expecting them to bank this money until they replace assets several years down the track.[34]

3.56 The Committee, however, considers that it is useful for accruing costs - such as depreciation and superannuation - to be identified in the forward estimates of government agencies, and for the Commonwealth to recognise such items as part of the cost of delivering government services and as expenses that must be funded in time.

3.57 The Committee has considerable difficulty seeing why Australia should maintain dual cash and accrual accounting and reporting systems indefinitely. This is likely to impede the acceptance of accrual accounting and reporting in government agencies and to confuse all those who try to monitor the financial position of the government.

32 Steve Sedgwick, Finance, *Transcript*, p. 178 (Canberra, 20 October 1995).

33 Steve Sedgwick, Finance, *Transcript*, pp. 169-72. (Canberra, 20 October 1995).

34 Steve Sedgwick, Finance, *Transcript*, p. 169-70 (Canberra, 20 October 1995). In New Zealand government agencies already submit accrual estimates. Appropriations are required for running costs, for assets sold at a loss, and for the purchase and development of assets. Funding is not provided for depreciation or losses on revaluation, for example.

3.58 Mr Sedgwick recognised the risk of having different measures of the government's financial performance floating around in the public arena if the budget continued to be cash based while the accountability cycle and ABS statistics moved to accrual reporting:

> *At the least ... we should go for the maximum congruence possible in the concepts and the coverage between our GFS [Government Finance Statistics] and whole of government accruals based statistics and be able to link as transparently as we can between budget statements on the one hand and the accounting statements on the other. To set all that out in a way that is transparent is going to be beyond most bureaucrats, let alone anyone else, I have to say. But to do that carefully and to articulate well what the linkages are I think is very important or we will risk misinterpretation because people do not understand how you get from the number which was published in the budget to the number that appears in any other statement aggregated across general government and ultimately whole of government.*[35]

3.59 The Committee agrees that it is highly undesirable to have different numbers for ostensibly the same financial indicators floating around in the public arena. However the Committee is not at all attracted to the idea of the Commonwealth publishing convoluted interpretive notes to its financial reports explaining why the numbers 'don't add up'. **The Committee believes the sensible way forward is for all financial reporting for the Commonwealth to move into the accrual environment.**

35 Steve Sedgwick, Finance, *Transcript*, p. 168 (Canberra, 20 October 1995).

3.60 In *Report 338* the Committee endorsed accrual budgeting.[36] The Committee recognised a basic incoherence in the continuation of cash budgeting and cash appropriations in an accrual accounting environment. The Committee recommended that the Government 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.[37]

3.61 The need for such a review remains, although the Committee believes it should focus on **how** accrual budgeting can best be implemented, not whether or not it should be implemented. That accrual budgeting **must** be implemented is a logical progression from the implementation of accrual accounting.

Fiscal responsibility legislation in an accrual environment

3.62 In this inquiry into fiscal responsibility legislation, the Committee has examined models of balanced budget and debt elimination legislation in other jurisdictions. Balanced budget requirements, mandatory debt elimination targets, statutory taxation and expenditure limitations, are creatures of a **cash** based accounting and reporting environment. If the principal measure of a government's financial performance is the cash deficit or surplus, then the objectives of fiscal responsibility legislation must be framed in terms of the cash deficit or surplus.

3.63 Fiscal responsibility legislation in an **accrual** based accounting environment will be fundamentally different from balanced budget legislation.

3.64 When effective whole of government reporting on an accrual basis is in place, a government's financial position over time, and thus the financial performance of successive governments, is more transparent. It is no longer necessary to use proxy measures of the government's fiscal responsibility.

36 *Report 338*, p. 72

37 *Report 338*, p. 72.

3.65 In an accrual environment, fiscal responsibility legislation establishes mandatory standards for fiscal reporting binding on successive governments, without attempting to dictate fiscal targets, knowing that the transparency of the government's financial decisions will be the discipline on fiscal performance.

3.66 Dr Louise Kloot, Senior Lecturer in Accounting, Swinburne University of Technology, submitted that fiscal responsibility legislation, as she envisaged it, 'would largely consist of "whole of government" and other new reporting standards, not simply require them as a minor adjunct'.[38]

3.67 In Dr Kloot's model, fiscal responsibility legislation would identify the indicators to be used to assess a government's performance and would require these indicators to be published in fiscal reports 'but [would not specify] the "level" to be reached or similar goal derived requirements'.[39]

Models of fiscal responsibility legislation

3.68 The Terms of Reference for this inquiry into fiscal responsibility legislation require the Committee to pay particular attention to:

- *the success of attempts to legislate for fiscal responsibility in other jurisdictions; and*
- *the relevance to the Commonwealth of the type of public reporting provisions contained in fiscal responsibility legislation in other jurisdictions.*

3.69 In line with the thrust of the Terms of Reference, the greater part of the time devoted by the Committee to this inquiry was spent examining models of fiscal responsibility legislation in other jurisdictions and considering how appropriate elements of these models would be for the Commonwealth.

38 Dr Louise Kloot, *Submission*, p. S8.

39 Dr Louise Kloot, *Submission*, p. S8.

3.70 The Committee conducted its own research into the models of fiscal legislation in place in the United States of America and in New Zealand.

3.71 As already outlined, two very different approaches to legislative disciplines on fiscal policy have been taken in other jurisdictions, viz:

- balanced budget legislation and other mandatory fiscal targets, operating in a cash based accounting environment - as in Europe, Japan and the USA; and
- fiscal responsibility legislation proper, operating in an accrual accounting environment and requiring a degree of fiscal reporting that makes the budget process transparent to the electorate, as in New Zealand and as proposed by governments in NSW and the Australian Capital Territory.

Fiscal responsibility legislation in Europe and Japan

3.72 Forms of cash based fiscal responsibility legislation are presently in place in Europe and Japan, as well as the United States of America.

3.73 The Maastricht Treaty on European Monetary Union sets 'convergence criteria' for the entry of individual countries into the European Monetary Union in 1999.[40] One of these criteria - that a country demonstrates a sustainable financial position - is measured against the reference benchmarks that its budget deficit should be not more than 3% of Gross Domestic Product (GDP) and that its debt should not exceed 60% of GDP.[41]

3.74 For those countries which adopt a common European currency in 1999, the Treaty provides for penalties - including fines and the required lodgement of non-interest bearing deposits with the Community - to be imposed on member countries failing to address 'excessive' deficits (as defined above).

40 The Treaty provides that a common currency could commence as early as 1997 but otherwise by 1 January 1999. The Treasury, *Submission*, p. S110.

41 The Treasury, *Submission*, p. S110.

3.75 France and Germany also have their own fiscal legislation.

3.76 In 1994, the Government of France legislated for five year guidelines to curb public expenditure with the aim of reducing the deficit by half a percentage point per year to 2.5% of GDP by 1997. The law caps outlays (including interest payments) to zero real growth and requires that higher than expected revenues must be used to accelerate deficit reduction. However, there is no legally binding requirement that each annual budget should conform to the law and the 1994 budget didn't.[42]

3.77 The Committee notes that the fiscal legislation in place in France appears designed to achieve the fiscal targets laid down in the Maastricht Treaty.

3.78 In Germany, the Grundgesetz Basic Law requires that budget revenue and expenditure must be balanced. Borrowing is limited to investment expenditure and/or 'to avert a disturbance of the overall economic equilibrium'. Under existing legislation, the federal government prepares its fiscal strategy in the context of a five year rolling financial plan. Under the 1996 Financial Plan, the Federal budget deficit is projected to fall close to 1% of GDP by 1999.[43]

3.79 Like Germany, Japan imposes restrictions on the extent to which borrowing can be used to finance current expenditure. Bond issues in Japan are limited under the public finance law to financing public infrastructure and equity investments. Deficit financing bonds can only be issued if special legislation passes through the Diet. Deficit financing bonds were issued in Japan from financial years 1975 to 1988, and from financial year 1994 to date.[44]

42 The deficit target was achieved in 1994 but outlays grew in real terms and higher than expected revenues were not used to reduce the deficit. The Treasury, *Submission*, p. S109.

43 The Treasury, *Submission*, p. S109.

44 The Treasury, *Submission*, p. S110.

3.80 The Committee accepts the general principle that borrowing should be used for investment expenditure - on the basis that both the costs and the benefits of this expenditure will be borne by future taxpayers. Nonetheless, neither Germany nor Japan have closed the door to borrowings for current expenditure from time to time. It should also be noted that there can be differing interpretations of what constitutes capital, as opposed to current, expenditure.[45]

3.81 In Australia, the Commonwealth's 1995-96 Budget Statements estimated a budget surplus for 1995-96 at 0.1% of GDP and Commonwealth net debt was projected to fall from 19.1% of GDP in 1994-95 to 13.7% of GDP by 1998-99.[46] Net public debt (Commonwealth and States) is projected to fall from its decade peak of 27.9% of GDP in June 1996 to 26.8% of GDP by June 1998.[47] In these circumstances, it could be argued that fiscal responsibility legislation in Australia is not being driven by the fiscal imperatives that seem to underpin fiscal responsibility legislation in Europe. Australia has already achieved the fiscal targets European countries are programmed to achieve by 1999.

The United States of America[48]

Federal government

3.82 At the Federal level in the United States, fiscal limits have been laid down in legislation since 1985.

45 The Treasury, *Submission*, p. S96.

46 Commonwealth of Australia, *Budget Statements 1995-96*, Budget Paper No. 1, pp. 1-1 & 1-9.

47 The projection for 1998 is based on a low growth scenario. *National Fiscal Outlook*, Report to the Premiers' Conference, 3-4 April 1995, p. 41.

48 The factual information in this section was provided to the Committee by the Treasury, *Submission*, pp. S104-07, except for material for which a specific reference is given. The Committee takes responsibility for comment and analysis unless otherwise attributed.

3.83 The purpose of fiscal laws has been to control the US federal budget deficit which is estimated at US$170.3 billion for the 1996 financial year and has been at higher levels in the last decade.[49]

Gramm-Rudman-Hollings Act

3.84 The *Balanced Budget and Emergency Deficit Control Act of 1985* (commonly referred to as the Gramm-Rudman-Hollings Act) set specific deficit targets for each fiscal year from 1986 through 1991, with the intention that the deficit would be progressively lowered in each year and be eliminated in fiscal year 1991.

3.85 The Gramm-Rudman-Hollings Act provided that, if at the beginning of a fiscal year, the deficit target for that year was not judged to have been met, automatic budget cuts would follow to ensure that the deficit target was met.

3.86 However, the deficit exceeded the targets for each of the years from 1986 through 1990. Some of the reasons suggested for the failure to achieve the fiscal targets under the Gramm-Rudman-Hollings Act include:

- that there was no effective provision in the Act for enforcing automatic cuts to meet targets;
- that the legislation protected most important programs from cuts, or only imposed cuts on cost of living adjustments; and
- that there was no mechanism to take account of the impact of forecast revisions on the deficit.

3.87 According to one commentator, the Gramm-Rudman-Hollings Act also

> *... led to a great deal of creative accounting by Congress and the invention of numerous different concepts of what a Budget deficit is.*[50]

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49 George Hager and Alissa J Rubin 'Congress gives resounding Yes to Balanced-Budget Plan' in *CQ*, 1 July 1995, p. 1905.

50 P P McGuinness, 'Fiscal policy in the balance', *The Australian*, reproduced in NSW Public Accounts Committee, *Inquiry into State Debt Control (Balanced Budget) Bill 1994* (December 1994) p. 233.

3.88 It has been suggested that the short term focus of the Gramm-Rudman-Hollings Act deficit targets resulted in a range of practices designed to shift outlays both between years and off-budget, including:

- meeting the current year deficit target by increasing subsequent year deficits, for example, through asset sales in the current year; and
- moving agencies off-budget.

3.89 Congress amended the Gramm-Rudman-Hollings Act in 1987 to adjust targets and extend the year by which the budget was to be balanced to 1993.

3.90 The Gramm-Rudman-Hollings Act has been further amended and extended by the *Budget Enforcement Act of 1990* and the *Omnibus Budget Reconciliation Act 1993.*

Budget Enforcement Act

3.91 The 1990 Budget Enforcement Act provided deficit control mechanisms on a multi-year basis from 1991 through 1995.

3.92 In contrast to the Gramm-Rudman-Hollings Act, the Budget Enforcement Act did not impose a deficit target, but rather a requirement that policy changes for a particular year not increase the estimated current and near term deficits (for a period of three years) relative to the levels forecast at the beginning of the current fiscal year. Asset sales could not be used to offset spending increases or tax cuts. Non-policy induced deficit increases were allowed.

3.93 To give effect to these requirements, the Act imposed the following control mechanisms on discretionary and direct (also called mandatory) spending.

3.94 **'Discretionary' spending** was controlled by caps across all discretionary programs (except the Violent Crime Reduction Trust Fund) over the three year horizon. The caps were intended to hold outlays roughly constant in nominal terms.

⇒ If estimated budget authority exceeded the cap within the fiscal year (before July 1), the Budget Enforcement Act specified a procedure, termed *sequestration*, for reducing discretionary spending such that the overall global spending cap applying was met during this period. Under a *sequester*, spending for most non-exempt programs was reduced by a uniform percentage so that the overall cap was met.

⇒ If the cap was breached after July 1 of the current fiscal year (the US financial year runs from 1 October to 30 September) any required reduction was taken from next year's cap.

3.95 **'Mandatory' or 'direct' spending**[51] in the United States is controlled by permanent laws and covers areas such as health, social security and welfare entitlements. Under the Budget Enforcement Act receipts were included under the same rules applying to direct spending since receipts are also generally controlled by permanent laws.

⇒ Automatic cuts to direct spending, called pay as you go (PAYGO) sequesters, were enacted if it was estimated that a net increase in the deficit would result from new laws affecting direct spending and receipts during a Congressional session. Cuts were achieved by reducing funding for most non-exempt programs by a uniform percentage.

⇒ PAYGO rules did not apply to increases in direct spending or decreases in receipts that were not the result of new laws. For example, a rise in benefit payments associated with increased unemployment was not subject to sequestration.

⇒ Sequestration was rarely implemented due to other solutions being arrived at before sequestration orders were activated.

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51 Mandatory/direct spending is a term used in the Budget Enforcement Act (USA).

3.96 The Act provided that the estimates and calculations determining whether a sequester was required were made by the Office of Management for Budget (OMB) and reported to the President and Congress. The Congressional Budget Office (CBO) was required to make the same estimates and calculations as the OMB and the Director of the OMB was required by the Act to explain any differences between the sets of estimates.

3.97 Dr Graeme Wells, Senior Lecturer in Economics, Australian National University, was concerned that the Budget Enforcement Act had had the following defects as a fiscal discipline:

- forecasting errors led to 'base drift' because the Act only required that the deficit not increase **relative to the forecast deficit** for a financial year;
- there was no presumption that the initial forecast deficit was, in any sense, optimal; and
- the emphasis on controlling taxes and expenditures did not capture the longer run effects of fiscal policy.[52]

Current proposals at the Federal level

3.98 On assuming office in 1993 the current US Administration enacted multi-year deficit reduction programs.

3.99 In June 1995 Congress passed the Balanced Budget Resolution which legislated to balance the budget by 2002. House and Senate committees[53] were required to review program budgets to produce the necessary $894 billion in spending cuts by 2002.[54] Presidential endorsement of the resulting reconciliation and appropriation bills is required.[55]

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52 Dr Graeme Wells, *Submission*, p. S234.

53 The Appropriation Committee is responsible for the appropriation bills; the House Ways and Means Committee examines revenue proposals; the Senate Finance Committee has responsibility for welfare and other expenditure; other committees - such as commerce and agriculture committees - have responsibility for specific items in the budget.

54 Hager and Rubin, 1995, p. 1899.

55 Hager and Rubin, 1995, p. 1905.

3.100 In response to the Congressional initiative the Administration brought forward further deficit reduction proposals for the period to 2005.

3.101 In 1994 the House passed a constitutional amendment requiring a balanced budget. Briefly, the amendment provided that the budget be balanced from 2002, with a four-fifths majority being required to allow the budget to go into deficit or the debt limit to be expanded. This amendment was narrowly defeated in the Senate, although there is some chance that it could be reintroduced. A two-thirds majority in both of the Senate and the House would be required to pass the amendment and then the support of three-quarters of the States would be required.

Lessons for Australia

3.102 Fiscal responsibility legislation at the Federal level in the United States has been designed to effect enforced deficit reduction. This is not an issue for the Commonwealth of Australia now nor in the foreseeable future.

3.103 It has been claimed that legislative fiscal controls in the United States grew out of the political failure of the US budgetary process and, in particular, the division of responsibility for the budget between the Administration and the Congress :

> *The case for legislatively-imposed rules rests on a view that the political system is such that only through legislative or constitutional enforcement can Governments be held to fiscal responsibility. ...*

> *The origin of this view of the political system is the United States, where the size and nature of the federal deficit blowout over the past decade is certainly evidence of political failure. However, the political failure involved is principally the result of the extreme version of the doctrine of the separation of powers in the US political system, which has led to a situation where both Congress and the Presidency have incentives to undermine effort made by the other to bring the fiscal position under control. This is not a problem in Australia.*[56]

3.104 However, the Committee was particularly impressed with certain elements of the US approach - in particular:

- the provision of independent budgetary advice to the Congress by the Congressional Budget Office; and
- the important role of Congressional Committees in formulating - not just reviewing - budget (expenditure and revenue) proposals.

These elements enhance the transparency of the budgetary process and strengthen the role of the parliament.

State government in the United States

3.105 Fiscal restraints have a long history at the State Government level in the United States. Many States adopted them in the 1840s following a wave of defaults and many new States have adopted them from inception since that time.

3.106 Forty-three of the fifty States currently have balanced budget requirements of a statutory or constitutional nature.[57] In addition, 22 States have adopted tax and expenditure limitations (TELs) which are designed to limit growth in government to defined economic factors such as the Consumer Price Index (CPI), income or population. Of these TEL States, 12 have constitutional provisions and 10 statutory provisions. Examples of specific provisions in place in two states are described below.

56 Professor Marc Robinson *Submission*, pp. S54-55. Steve Sedgwick, Secretary, Department Finance, also raised this point in evidence, *Transcript*, p. 6 (Canberra, 8 September 1995).

57 Exhibit No. 32.

3.107 **Missouri** has a constitutional debt ceiling of US$1 million for casual deficiencies or emergencies and this debt must be repaid within 5 years. All other state indebtedness requires voter approval and voters have approved a series of debt raisings for specific purposes. There are 'sunshine' (disclosure) laws and reporting requirements. In 1980 voters approved a series of constitutional TEL amendments limiting revenue to a base year amount indexed to growth in the total personal income of State residents. Any surplus revenue over 1 per cent must be refunded to taxpayers. Expenditure is limited to State revenue plus federal transfers plus any surplus from the previous year that was not required to be refunded. These provisions are prospective in nature, constraining the following year's budget as it is being prepared and estimated.[58]

3.108 **Texas** has a constitutional debt ceiling of US$ 200 000 for casual deficiencies. The budget must be balanced unless approved by four-fifths majority of the legislature. There are legislative voter approval requirements for the raising of certain debt not constitutionally constrained. There are public notice requirements for tax increases. TEL requirements apply only on the revenue side and are retrospective, with any annual revenue increase greater than 8% subject to an automatic election on whether the increase should be rolled back. State revenues cannot grow at a pace faster than the growth of the State's economy but the legislature has some discretion in interpreting this provision.[59]

3.109 The balanced budget and TEL provisions in State jurisdictions are considered to have been reasonably successful in limiting growth in state indebtedness.

58 C W Golder, 'State and local government fiscal responsibility: an integrated approach', *Wake Forest Law Review*, Vol. 26 (4), 1991, pp. 956-60. The Treasury, *Submission*, p. S107.

59 C W Golder, 1991, pp. 960-62. The Treasury, *Submission*, p. S107.

3.110 However, ways have been devised to avoid the limits including by placing items off-budget. One estimate found that around 44 per cent of State appropriations were outside the general fund and so were not subject to TELs.[60] It has also been suggested that TELs distort revenue raising into uncontrolled areas such as increases in licence fees, user charges and so on.[61]

3.111 A number of jurisdictions in the United States have experienced fiscal crises despite their having to meet balanced budget and/or debt limitation requirements.[62]

3.112 For example, Cleveland (Ohio) defaulted on its municipal borrowings in 1978 after using bond issues to finance recurrent expenditure in blatant breach of Ohio fiscal laws.[63] Cleveland incurred these debts during a period for which the State of Ohio declared the accounts of the City of Cleveland unauditable.[64] Ohio has since legislated to require its political subdivisions to file annual financial reports with the state auditor using accounting standards prescribed by the state auditor.[65]

3.113 Professor Charles Golder, Little Rock School of Law, University of Arkansas, writing about fiscal restraints at the State and local government levels in the United States, has proposed that an important ancillary aid to fiscal responsibility is **transparent fiscal reporting requirements.** He argues:

60 The Treasury, *Submission*, p. S107.

61 C W Golder, 1991, p. 955.

62 C W Golder, 1991, pp. 925-63.

63 The fiscal laws for the State of Ohio, inter alia, limited debt and prohibited the use of bond proceeds for funding recurrent expenditures. C W Golder, 1991, pp. 941-43.

64 C W Golder, 1991, p. 940.

65 C W Golder, 1991, p. 943.

Statutes mandating the use of responsible accounting standards and government in the sunshine[66] *have a significant effect on efforts to achieve fiscal responsibility. Critical analyses, or at least a conscious awareness by the electorate of expenditures and borrowing can serve as a powerful check in a representative system of government. If the electorate is not informed, it cannot serve as an effective check on government expenditures and borrowing devices; the electorate must know what is being done in the state house or at city hall. ... Financial reports must be timely, understandable, and prepared pursuant to required guidelines that accurately reflect the government's fiscal condition.*[67]

3.114 It is relevant that a number of states in the US have moved, or are in the process of moving, to full accrual accounting - partly in response to the demands of the bond rating houses for more accurate fiscal information. Seventeen states now prepare their budgets according to Generally Accepted Accounting Principles (GAAP).[68]

Relevance for the Commonwealth of Australia

3.115 The Committee does not consider the forms of fiscal restraint applying to State legislatures in the United States to be appropriate for the Commonwealth.

3.116 For a start, the Committee is not convinced that there is a need for the Commonwealth Government to be subject to such tight fiscal constraints. Part of the rationale for such restraints in the United States is said to be that party discipline is not strong enough to constrain 'pork-barrelling' by members of State legislatures who are under pressure to deliver State funding to their respective electorates.[69] Party discipline in Australia has traditionally been strong and, from time to time, reflected in the achievement of tight fiscal policies.

66 'Sunshine' laws mandate disclosure of information about the activities of government, including financial information.

67 C W Golder, 1991, p. 939.

68 Exhibit No. 32.

69 P P McGuinness, 'US deficit rules won't work here' in *The Australian Financial Review*, 3 March 1995.

3.117 Furthermore, there is a strong argument that balanced budget requirements are far more appropriate at the State or municipal level of government - where governments are chiefly service providers - than at the Federal level, where the government is responsible for macroeconomic management.

3.118 There is also a strong argument that strict fiscal constraints don't work - simply encouraging creative accounting. The case against balanced budget legislation in Australia has been summarised in the following terms by Mr Padraic McGuinness, a commentator on social and economic affairs:

... balanced budget amendments make good populist slogans, and appeal to those who think that you can legislate for virtue.[70] *(But) 'if a government is honest and conscientious you don't need a BBA [Balanced Budget Amendment] and, if it is not, a BBA will not stop it.*[71]

3.119 Finally, the Committee notes that State legislatures in the United States are recognising the importance of accrual accounting and more transparent reporting as an important part of fiscal discipline.

3.120 At this point, the Committee moves on to examine models of fiscal responsibility legislation where transparent reporting on an accrual basis is the key requirement.

New Zealand's fiscal responsibility legislation[72]

3.121 The Committee gave particular attention to the *Fiscal Responsibility Act 1994* (New Zealand) because it appears to be the first such legislation designed to operate in an accrual accounting environment.

70 P P McGuinness, 'Bean-counters offer balance to Government excesses', *Melbourne Age*, 3 February 1995.

71 P P McGuinness, 'Budget poll is a stunt', *Sydney Morning Herald*, 1 December 1994.

72 The factual information contained in this section is based on an analysis of the legislation itself, and the fiscal reports that have been produced to date as required by the legislation - provided to the Committee by the New Zealand High Commission and included in the Committee's records as Exhibits Nos. 2, 4, 5 & 6.

3.122 This legislation was developed and implemented in circumstances of fiscal crisis in New Zealand. Dr Graeme Wells traces the roots of this fiscal crisis back to decisions taken by the New Zealand Government in the 1970s including:

- the introduction of the National Superannuation Scheme, resulting from 'vote-bidding' in the 1975 election campaign;
- government sponsorship of petrochemical projects; and
- farm price support schemes. [73]

3.123 The ultimate fiscal consequences of these policies were not at all apparent to the public because of the cash based format in which fiscal reports were then presented. The above items were largely 'off-budget' and/or not disclosed because of the contingent nature of the Government's commitments.[74]

3.124 Dr Graeme Wells stressed the seriousness of the fiscal accountability problems in New Zealand prior to the introduction of fiscal responsibility legislation:

> *... I would not want my statement that it was necessary to get out of dire economic circumstances to be interpreted as saying that there were not dire accountability problems as well. That is reflected in the fact that I think it was in 1986 that the government just wrote off about $8 billion of bad investments. If you think of New Zealand's economy compared to ours, that is equivalent to the Commonwealth government writing off about $40 billion in one year. That is a pretty bad accountability problem and I would argue that that accountability problem in part led to the economic problems.*[75]

73 Dr Graeme Wells, *Submission*, p. S233

74 Dr Graeme Wells, *Submission*, p. S233. For example, the reserve price schemes for lamb and dairy products were 'off-budget'. The guarantees given to natural gas developers were based on expectations that the price of oil was going up and would remain high; when the price of oil fell, the government unexpectedly had to pick up the guarantees. *Transcript*, p. 154 (Canberra, 19 October 1995).

75 Dr Graeme Wells, *Transcript*, p. 154 (Canberra, 19 October 1995).

3.125 Two particular events prior to the 1990 election in New Zealand focused attention on the need for more transparent and comprehensive reporting by government. In October 1989, the Development Finance Corporation - owned by the government statutory authority responsible for managing public servants' pension funds - failed, owing Japanese bankers more than $NZ 1 billion. Then, after winning office in 1990, the incoming government discovered that the government-owned Bank of New Zealand was insolvent - a fact that had been known to the government, but not the opposition, during the election campaign.[76]

3.126 New Zealand's fiscal responsibility legislation was introduced in this context.

3.127 The introduction of fiscal responsibility legislation in New Zealand was accompanied by the implementation of accrual accounting, whole of government reporting and new reporting standards in line with the requirements for the Crown financial statements laid down in the *Public Finance Act 1989*.

3.128 The fiscal reports now produced in New Zealand - and the budget cycle itself - are based on whole of government reporting on an accrual basis. It is impossible to distinguish the separate impacts that whole of government reporting/accrual budgeting and fiscal responsibility legislation have had on government accountability in New Zealand. They are parts of an integrated strategy.

3.129 Contrary to the legislative fiscal constraints imposed in a cash accounting environment, New Zealand's *Fiscal Responsibility Act 1994* does not set any specific fiscal targets. It aims to achieve fiscal discipline by:

- setting out **five principles of fiscal responsibility** that must be observed by the government as it draws up its budget;
- imposing on the government **frequent public reporting requirements**; and
- establishing a regime for **parliamentary scrutiny** of these reports.

The main features of the Act are outlined below.

76 Dr Graeme Wells, *Submission*, p. S233.

Five principles of responsible fiscal management

3.130 The Act lays down five principles for fiscal management - in summary:

- reducing Crown debt to prudent levels;
- maintaining these levels by ensuring that Crown operating expenses do not exceed operating revenues over a reasonable period of time;
- achieving and maintaining levels of Crown net worth that provide a buffer against factors that may impact adversely on the Crown's net worth in the future;
- managing prudently the fiscal risks facing the Crown; and
- pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.[77]

3.131 The Fiscal Responsibility Bill, as first introduced into the New Zealand Parliament in 1993, did not incorporate principles of fiscal responsibility but relied solely on transparent reporting requirements to discipline government. The Bill was

> ... *neutral as to the fiscal stance that a government may choose to adopt. No restrictions [were] placed on the Government's decision-making ability but the Government [was] required to be explicit about its overall approach and the fiscal consequences of that approach.*[78]

3.132 The principles of fiscal responsibility were adopted on the recommendation of the Finance and Expenditure Committee of the House of Representatives (NZ), following that Committee's inquiry into the Bill.

77 Section 4 of the *Fiscal Responsibility Act 1994* (NZ).

78 House of Representatives Finance and Expenditure Committee (NZ), *Report of the Finance and Expenditure Committee on the Fiscal Responsibility Bill* (1994) p. 5.

3.133 The Finance and Expenditure Committee had heard arguments from economists and business interests, some of whom supported explicit fiscal targets and others who favoured looser fiscal goals, but all of whom were convinced that future fiscal policy should not be at the complete discretion of the government of the day.[79]

Reporting requirements

3.134 The reporting requirements remain the key provisions in the legislation, designed to 'make the fiscal policy process so transparent that it is very difficult for a government to introduce irresponsible policies'.[80]

3.135 The Act requires the Minister for Finance to publish a series of fiscal reports, namely the:

- **pre-budget report**: at least three months before the start of each financial year, the Budget Policy Statement containing the Government's long term objectives for fiscal policy, its broad strategic priorities for the next budget, and its fiscal intentions for three financial years;
- **budget report**: a Fiscal Strategy Report assessing the consistency of the budget with the Budget Policy Statement, providing progress outlooks for the next ten years and an economic and fiscal update prepared by the Treasury for the next three years;
- **half-year update**: in December each year, an economic and fiscal update prepared by Treasury for the next three years;
- **pre-election report**: before each general election, an economic and fiscal update prepared by Treasury for the next three years; and
- **fiscal update**: towards the end of each financial year, a fiscal update prepared by the Treasury for that year, including forecast estimated actual financial statements for the Crown.

79 Finance and Expenditure Committee (NZ), 1994, pp. 8-16.

80 Alan Wood, 'Clear argument for fiscal transparency', *The Australian*, 7 February 1995.

Parliamentary scrutiny

3.136 The fiscal reports stand referred to the parliamentary committee responsible for the overall review of financial management in the public sector - presently the Finance and Expenditure Committee.

3.137 The Standing Orders of the House of Representatives in New Zealand were amended to permit the Committee to examine the Minister of Finance (who tables fiscal reports), the Secretary to the Treasury, and any other relevant experts, on fiscal reports.

3.138 In particular, the pre-budget fiscal policy statement is referred to the Committee for inquiry and report. It is understood that submissions to this inquiry are sought and forthcoming and that public hearings are televised, in response to the high level of public interest in the debate.

Conclusions

3.139 Taken together, the provisions of the Fiscal Responsibility Act are said to provide 'for better information and analysis, a stable reporting cycle, a greater focus in reporting on strategy, less secrecy about budget planning, more scrutiny by parliament and benchmarks for assessing fiscal policy'.[81]

Comparison of fiscal reporting in Australia and New Zealand

3.140 The Committee's Terms of Reference direct particular attention to the type of public reporting provisions contained in fiscal responsibility legislation in other jurisdictions.

3.141 As described above, the New Zealand model of fiscal responsibility legislation places particular reliance on public reporting provisions. The Committee considered whether or not similar reporting provisions would be useful in Australia.

81 Dr Graham Scott, 'New Zealand's Fiscal Responsibility Act' in *Agenda*, Volume 2 Number 1, 1995, p. 9.

3.142 The Committee sought to compare the extent of fiscal information already published in Australia with that provided in New Zealand pursuant to the Fiscal Responsibility Act and to assess the likely usefulness of further information and the estimated administrative cost of preparing and publishing such further information.

3.143 Key witnesses to the Committee's inquiry, principally Finance and the Treasury, pointed out that Australia's financial reporting had been far more effective than that applying in New Zealand prior to the introduction of fiscal responsibility legislation and that, therefore, Australia was not under the same pressure to adopt fiscal responsibility legislation. Mr Steve Sedgwick, Secretary of the Department of Finance observed:

> *New Zealand introduced [fiscal responsibility] legislation because they faced a particular set of circumstances. They were in really big trouble. They wanted to be able to get control over their estimating processes and over their budgeting processes in a way which enabled them to achieve the objective, which was significantly reduced budget deficits and, ultimately, surpluses. This was in order to be able to get the levels of their debt, which were very high, under control. You know the New Zealand story. They began in circumstances that were rather more desperate than ours. ...*
>
> *One of the factors which the New Zealanders regarded as being important was truth in government - to have data on the public record that had integrity about it and to have a framework within which policy could be judged. I suppose this is a biased comment because it is us that we are talking about: one thing that is important in our context is that our budget numbers do have a very high degree of integrity, and our budget numbers [including the forward estimates] do not simply focus on the budget year. ...*

> *The approach that we have, where we compile estimates against an objective set of standards that we keep and publish a set of numbers that reflects the effect of policy in the budget year and the next three years, is that we have a pretty good base on which we can judge the implications of existing policy over a period of time ... - and New Zealand did not have that.*[82]

3.144 This is undeniably so. Dr Graham Scott, former Secretary of the New Zealand Treasury has also made this point.

> *New Zealand's budget system was beset by untidy and changing processes through stresses in the 1980s that harmed fiscal outcomes. In contrast, Australian federal budgetary systems at the time were characterised by tightness and stability. New Zealand adopted some Australian innovations, such as the use of baseline forecasts from the previous year to initiate the preparation of the current budget.*[83]

3.145 However, there is a serious question as to whether or not New Zealand has 'leapfrogged' Australia in terms of financial accountability.

3.146 Australia is now working towards the preparation of whole of government reports on an accrual basis. New Zealand has already achieved this transition.

82 Steve Sedgwick, Finance, *Transcript*, pp. 7-8 (Canberra, 8 September 1995).

83 Graham Scott, 1995, p. 11.

3.147 On the basis of the Committee's own analysis, New Zealand's budget reports lead Australia's Budget Papers in the following significant respects:

- New Zealand prepares **whole of government reports on an accrual basis** with three year forecasts or projections for an extensive range of indicators of financial performance - including measures of Crown assets, liabilities and net worth; Australia's Budget Papers provide budget year estimates and a further three years forward estimates of cash aggregates.
- New Zealand publishes **three year forecasts or projections of borrowings**, distinguishing foreign currency debt from $NZ debt; Australia publishes information on the financing requirement for the budget year.
- New Zealand publishes three year estimates or projections of a wide range of **economic variables**; Australia provides comprehensive economic forecasts only for the budget year.[84]
- New Zealand publishes **ten year fiscal outlooks**; Australia publishes fiscal estimates for no more than four years.

3.148 It appears likely that any move by the Commonwealth to whole of government reporting would address some of the above points. The Treasury suggested that this would be the case.[85]

84 However, projections of real GDP, employment, the CPI and average weekly earnings beyond the Budget year are published.

85 The Treasury, *Submission*, p. S271.

3.149 Pursuant to the requirements of its fiscal responsibility legislation, New Zealand prepares more detailed and more frequent fiscal reports than are available in Australia. Fiscal reports available in New Zealand for which there is no obvious Australian equivalent include:

- the **Fiscal Strategy Report**, *tabled on budget* night, **providing progress outlooks for the next ten years** for key fiscal variables;
- the **Budget Policy Statement,** published in March each year, explaining the fiscal stance to be taken in the forthcoming budget and specifying measurable short-term and long-term fiscal targets against which the Government's fiscal performance can be assessed;[86]and
- the **Economic and Fiscal Updates**, published in March, June, December and prior to an election, giving revised fiscal forecasts or projections for the next three years.

3.150 A summary comparison of the fiscal reports provided in Australia and New Zealand appears in Table 3.1 below.

86 For example, one current fiscal target is to reduce net public debt to less than 20% of GDP. Exhibit No. 6.

Table 3.1 Fiscal reports in New Zealand and Australia[87]

New Zealand	Australia
(Pre) Budget Policy Statement specifying fiscal targets- published by 31 March	
Budget Report setting out short and long term fiscal goals and conformity of budget policies to these goals - tabled on Budget night	• Treasurer's Budget Speech • Budget Statement No 1 (Summary of the Budget)
Fiscal Strategy Report 10 year fiscal progress outlooks - tabled on Budget night	
Budget Economic and Fiscal Outlook forecasts of fiscal and economic variables for the next 3 years - tabled on Budget night	• Budget Papers including forward estimates • National Fiscal Outlook prepared for Premiers' Conference
Crown Financial Statements report financial position of government on an accruals basis • half year accounts published in February • full year accounts after end of financial year	• Final Budget Outcome (actual outlays against estimates for previous year) - published in August • Minister for Finance, Aggregate Financial Statement (audited accounts of the transactions of the Consolidated Revenue Fund, the Loan Fund and the Trust Fund for previous year) - published in December
Fiscal update and supplementary estimates - published in March	
Economic and Fiscal Update - published in December	Mid-year Review
Pre-election fiscal update	
Financial Out-turns- monthly statements of the Crown's financial position, including operating statement, cash flow statement and statement of borrowings	Commonwealth Government Statement of Financial Transactions (CFT) providing end-of-month and cumulative balances for government expenditure by category

87 The information on Australia's financial reporting was provided by Finance, *Submission*, pp. S87-92 and the Treasury, *Submission*, pp. S275-76.

3.151 The above summary comparison, if anything, understates the extent to which Australia's fiscal reporting trails the New Zealand regime, since, in many cases, the New Zealand reports are far more comprehensive than their Australian counterparts.[88]

3.152 The most obvious data gaps in the Australian reports, compared to the New Zealand reports, relate to:

- fiscal updates, which are prepared quarterly in New Zealand;
- long range fiscal progress outlooks;
- the pre-budget fiscal report; and
- the pre-election fiscal report.

Fiscal updates

3.153 Finance was of the view that fiscal updates for the Commonwealth as per the New Zealand model were not practicable. The Secretary of the Department of Finance, Mr Steve Sedgwick, explained

> *The updates that we do are related to a budget cycle. So the material which would become available, and does become available, becomes available just before a budget. ... So what additional information parliament would secure if it linked a reporting cycle with our present updating cycle, which is linked to a budget cycle, I do not think would be very much.*[89]

88 The Committee heard criticism of Australia's most recent half year economic update by the Treasurer. The Treasury provided a copy of the Treasurer's mid-year press release to the Committee - a 4 page summary, including two pages of quantitative information. The Treasury, *Submission*, pp. S286-89. The New Zealand half-year update provides updated estimates for the next 3 years for virtually all the information contained in the budget papers. The Business Council of Australia called for the presentation of more comprehensive data in the Mid-Year Review, *Submission*, p. S144.

89 Steve Sedgwick, Finance, *Transcript*, p. 11 (Canberra, 8 September 1995).

3.154 The Committee notes that this comment pertains to the present cash accounting environment. The question of what fiscal updates might be published should the Commonwealth move to an integrated accrual accounting/reporting/budgeting framework, as favoured by the Committee, is considered at the end of this chapter.

Fiscal forecasting

3.155 In New Zealand, fiscal forecasts or projections are made three years into the future and long range fiscal progress outlooks are made ten years into the future. The Economic and Fiscal Outlook tabled with the budget papers in New Zealand also forecasts key economic variables such as the CPI, interest rates, unemployment, exchange rates and so on for the budget fiscal year and the next two years.

3.156 Australia publishes fiscal estimates for the budget year and the next three years, and a limited range of economic projections for the same period (namely real GDP, employment, the CPI and AWE[90]). The Commonwealth does not publish long term fiscal outlooks.

3.157 The *National Fiscal Outlook* prepared for the Premiers' Conference in April each year provides three year projections of net debt, real GDP, employment, wages and the CPI. However, as Dr Graeme Wells has pointed out,

> *... the accounts are not prepared on an accruals basis and the time horizon is relatively short. Reflecting their federal basis, the projections are not tabled in any of the relevant parliaments; responsibility for their content is diffuse, and they are not subject to usual parliamentary scrutiny.*[91]

90 Average weekly earnings.

91 Dr Graeme Wells, *Submission*, p. S237.

3.158 Dr Graeme Wells considered that it would be useful for long term fiscal outlooks to be published in Australia. Asked if it was practical to be projecting out as far as 10 years, Dr Wells replied:

> *I think it is practical and I think it is important too. Ten years ... is a period that is longer than the short term fluctuations that most policy seems to focus on, and it is long enough to start picking up some of the effects of demographic change and things like that which are presently driving a lot of Australian policy in terms of superannuation and so on. ... 10 years seems to pick up something that is outside both the electoral cycle and the business cycle and it is long enough to start thinking about some of the impacts of things like demographics or changing patterns in school enrolments and so on.*[92]

3.159 The Treasury did not support the publication of more economic forecasts. Opposing the publication of its forecasts, the Treasury submitted:

- that forecasts of economic variables beyond the budget year would inevitably be less reliable than those currently published;
- that the publication of unreliable forecasts or forecast (economic) assumptions could raise risks of financial instability; and
- that private sector bodies in Australia publish their forecasts of economic indicators, including for economic variables not forecast in the Budget Papers.[93]

3.160 The Committee considers that best available fiscal and economic forecasts should be published for the information of parties, other than the government, that need to make medium to long term investment decisions. The Committee also considers it would be healthy for Treasury forecasts to be published - so that the forecasts on which policy decisions are made can be subjected to public scrutiny, and so that the accuracy of Treasury forecasts can be monitored over time.

92 Dr Graeme Wells, *Transcript*, p. 153 (Canberra, 19 October 1995).

93 The Treasury, *Submission*, pp. S274 & 278-79.

3.161 As far as the parliament itself is concerned, the Committee is of the view that it is desirable for parliament to have available the information on which to debate future fiscal policy for Australia. It is not enough for parliament to have estimates of future Departmental expenditure; this is a very small part of the picture.

3.162 The Committee considers there is a need for medium term fiscal estimates and economic forecasts to be published in the Budget Papers. The Committee returns to this issue towards the end of this chapter.

Pre-budget fiscal statement

3.163 The pre-budget policy statement is another feature of New Zealand's fiscal responsibility legislation that did not appear in the original Bill but was recommended by the Finance and Expenditure Committee following its public inquiry into the Bill.[94]

3.164 The idea was proposed by Dr Graham Scott, former Secretary to the Treasury in New Zealand. Dr Scott proposed the pre-budget fiscal statement to promote 'greater integration between fiscal strategy and the overall strategy for economic and social policy'.[95]

94 Finance and Expenditure Committee (NZ), 1994, p. 19.

95 Finance and Expenditure Committee (NZ), 1994, p. 18.

3.165 The advantages of the pre-budget fiscal statement were reported to include that:

- *the statement will reveal whether the Government's immediate fiscal plans are consistent with the principles of responsible fiscal management;*
- *subsequent fiscal decision-making and performance can be judged against the statement;*
- *it allows the Government to set out the reasons for any departure from the principles and the path back to those principles;*
- *it separates out debate on the overall fiscal strategy from questions of detailed budget allocations and thereby make[s] trade-offs more explicit; and*
- *it is a positive step towards a more open budget process which is likely in the MMP [Mixed Member Proportional voting system][96] environment.[97]*

3.166 The Committee is attracted to the idea of a pre-budget fiscal statement, but for reasons of its own. The Committee returns to this issue at the end of this chapter.

Pre-election fiscal statement

3.167 New Zealand's pre-election economic and fiscal update for the next three years is prepared by Treasury and published not earlier than 42 days and not later than 28 days before polling day. The report must be 'signed off' by the Minister for Finance and the Secretary of the Treasury.

3.168 It is argued that such a pre-election report would preclude newly elected governments from rescinding electoral promises on the basis that the previous government's financial position was worse than they had anticipated. Not only the opposition, but also the voting public, has access to a comprehensive overview of the government's financial position, including future liabilities. The electorate is thus less likely to excuse backtracking on election promises.

96 In the MMP environment, there was considered to be a greater risk of minorities undermining the overall fiscal strategy.

97 Finance and Expenditure Committee (NZ), 1994, p. 18.

3.169 The Committee sought professional advice from Treasury on the possible format and content of a pre-election financial statement for Australia. The Treasury would not provide this advice.[98] The Treasury considered it was for the government and the opposition to put out their own economic statements prior to an election and for the electorate to judge.[99]

3.170 The Committee attempted to distinguish between pre-election economic statements that were 'electioneering propaganda'[100] and the type of pre-election report prepared in New Zealand pursuant to the *Fiscal Responsibility Act 1994* which must be 'signed off' by both the Minister for Finance and the Secretary of the Treasury as providing a complete picture of the country's financial position, prepared using best professional judgement and the most recent statistics to hand.[101]

3.171 The Treasury could not envisage that an impartial financial statement for the Commonwealth could be prepared by Treasury in the run-up to an election.[102] The Treasury submitted:

> *Whether and what statements about the economic and financial outlook are made in the pre-election period is a matter for the Government and Opposition. Such statements depend not only on information about the current state of the economy and public finances, but also on views - which may legitimately differ - about prospective economic conditions and events and, importantly, on the present and future stance of policy.*

98 Rod Shogren, the Treasury, *Transcript*, p. 27 (Canberra, 8 September 1995). Bruce Taplin, the Treasury, *Transcript*, pp. 142-48, (Canberra, 4 October 1995). The Treasury, *Submission*, p. S 269.

99 Rod Shogren, the Treasury, *Transcript*, p. 27, (Canberra, 8 September 1995).

100 Senator Belinda Neal, *Transcript*, p. 27, (Canberra, 8 September 1995).

101 Section 12 of the *Fiscal Responsibility Act 1994* (NZ).

102 Rod Shogren, the Treasury, *Transcript*, pp. 27-29 (Canberra, 8 September 1995).

There is little apparent value in codifying the sorts of economic or financial indicators that political parties would be required to address in pre-election statements, and no prospect that general agreement could be reached on which were most telling or relevant.[103]

3.172 The Committee observed that the electorate could lose faith in the system of public accountability if the financial statements of government in Australia were repeatedly shown to be lacking, asking the Treasury:

... how many times have we seen recently a change of government and the incoming government finds that all the economic forecasts, the data that they were fed, were wrong, the parlous state of the public purse means that they cannot fulfil all their election obligations ... This makes people angry. This is what ... happened in New Zealand - people got angry and lost faith in the public system, and it is happening in Australia, more at the state level than the federal level. But it is a legitimate question to ask. Can you get a set of figures before an election that have integrity, that will stand up after the election, so that if there is a change of government the incoming lot cannot say, 'Oh, we didn't know the kitty was empty'?[104]

3.173 The Treasury declined to advise on this matter on the grounds that it was a political question.[105]

3.174 The Committee does not accept that the formulation of a pre-election fiscal report - containing factual information on the Commonwealth's financial position according to pre-determined and agreed reporting standards and explicit assumptions - need be a political question. The Committee rejects what little advice it received from the Treasury on pre-election fiscal statements.

103 The Treasury, *Submission*, p. S269.

104 Alex Somlyay MP, *Transcript*, p. 27 (Canberra, 8 September 1995).

105 Rod Shogren, the Treasury, *Transcript*, p. 27 (Canberra, 8 September 1995).

3.175 However, the Committee itself does not favour the publication of a pre-election report. In the accrual reporting environment envisaged by the Committee, there would be no need for a pre-election statement since comprehensive fiscal reports and updates would already be in the public arena. An additional pre-election fiscal update would be redundant.

3.176 The Committee is also concerned at the unreasonable burden that a pre-election reporting requirement could put on the reporting departments when a 'snap' election is called.

Is the New Zealand reporting model appropriate for the Commonwealth?

3.177 The short answer to this question is, 'No'.

3.178 The reasons for this conclusion will become apparent later in the chapter when the Committee formulates its own model of fiscal reporting for the Commonwealth.

3.179 Nonetheless, it is clear that the fiscal reporting regime in Australia as it presently exists **does not measure up to fiscal reporting in New Zealand** in important respects. The Committee makes recommendations later in this chapter to remedy the serious deficiencies in fiscal reporting in Australia - **most of which deficiencies derive from the retention of a cash based system.**

3.180 In the meantime, it is instructive to examine which elements of the New Zealand model have been picked up in Australia by the NSW Government.

Fiscal responsibility legislation in NSW

3.181 There is presently no fiscal responsibility legislation in place in any Australian jurisdiction. However, the State Treasurer introduced into the Parliament of NSW in 1995 a General Government Debt Elimination Bill which is, in essence, fiscal responsibility legislation.

3.182 The NSW Bill, if enacted would establish:

- non-mandatory fiscal targets directed at eliminating public debt by 2020;
- fiscal principles against which Budgets could be benchmarked;
- reporting requirements for the general government sector; and
- standards for the coverage and presentation of the Budget and Consolidated Financial Statement of the NSW Government.[106]

3.183 The NSW model of fiscal responsibility legislation draws heavily on elements of the New Zealand model.[107] In particular, there are stated principles of fiscal responsibility, these being:

- adherence to financial targets (that is, the elimination of net debt for the general government sector[108]);
- maintenance and growth of the 'net worth' of the general government sector;
- full funding of all new superannuation liabilities of government agencies and enterprises and progressive funding of past unfunded superannuation liabilities;
- asset maintenance;
- constraint of net cost of services and budget outlays (both current and capital);
- prudent risk management; and
- tax restraint.[109]

106 Hon Michael Egan, Treasurer of NSW, *Financial Statement* (June 1995) pp. 23-30. Also General Government Debt Elimination Bill 1995.

107 NSW Treasury, *Submission*, p. S208.

108 General government net debt is lower than total debt because liquid financial assets are traded against debt; general government net debt is distinct from net debt of government trading enterprises which have capital structure policies in place. NSW Treasury, *Submission*, pp. S208 & 213.

109 NSW Treasury, *Submission*, pp. S208-10.

3.184 These principles, obviously, are not a direct 'take' from the New Zealand legislation but reflect similar underlying concepts of fiscal responsibility. The other major similarity between New Zealand and NSW models is the heavy reliance on fiscal reporting requirements and the move to whole of government reporting on an accrual basis to better reflect the long term fiscal consequences of policy decisions.[110]

3.185 The NSW proposal differs from the New Zealand model in important respects. The NSW Bill provides for an annual fiscal report to be tabled at budget time containing three year fiscal projections and for a half-yearly fiscal report containing current budget year updates only. There is no present intention to introduce quarterly fiscal reports, a pre-budget fiscal report, nor a pre-election fiscal update.[111] NSW considered that a requirement to have the Secretary to the Treasury 'sign off' fiscal reports had the potential to politicise the position of the Treasury and so this feature of the New Zealand system has been dropped.[112]

3.186 The NSW Treasurer, commending the General Government Debt Elimination Bill in his Financial Statement of June 1995, observed as follows.

> *The legislation will establish a sound, prudent financial framework for New South Wales going into the next century. It is consistent with the identified need to increase national savings. It introduces standards of honesty and accountability into the Budget process that are unparalleled in any Australian jurisdiction.*[113]

110 Financial reporting practice in NSW is described in detail in Appendix IV to this report.

111 NSW Treasury, *Submission*, pp. S212-13.

112 NSW Treasury, *Submission*, p. S212.

113 Hon Michael Egan, 1995, p. 2.

Why legislate for fiscal reporting?

3.187 The current practice of the Commonwealth Government is to outline the Government's fiscal policy stance in a speech delivered when the Budget is tabled in the parliament. From time to time the Commonwealth Government has used fiscal targets and it has been the Budget speech and documentation which have provided the forum where fiscal performance has been assessed against these benchmarks.[114]

3.188 At present, there is no legislative requirement for the preparation or tabling of certain of the key Budget Papers in any form. The Treasurer and the Minister for Finance circulate the Budget Papers to Members and Senators to facilitate the passage of the Appropriation Bills.[115]

3.189 Although the form and content of the Budget Papers 'is the prerogative of the Government'[116] rather than determined by legislative requirements, conventions as to budget presentation have been developed, and respected, over time.

Is it desirable to legislate fiscal reporting requirements for the Commonwealth?

3.190 The key provisions in fiscal responsibility legislation in New Zealand and NSW are fiscal reporting requirements. This raises the issue of whether or not it is desirable to legislate fiscal reporting requirements for the Commonwealth.

114 The Treasury, *Submission*, p. S100.

115 Certain information in the Budget Statements is required for the Appropriation Bills. However there is no requirement for the publication of Budget Paper No. 1 - which is the principal annual report on the Australian economy and on the Commonwealth's fiscal position and strategy.

116 The Treasury, *Submission*, p. S280.

3.191 The Committee has already noted that Australia's fiscal reports do not compare favourably to those published in New Zealand under its Fiscal Responsibility Act.[117]

3.192 The Committee is aware from its own inquiries that the Commonwealth trails some of the Australian States and Territories in the application of new accounting and reporting practices.[118]

3.193 The major criticisms of the cash based Budget Papers and other fiscal reports currently published for the Commonwealth were that:

- no distinction is make between the current and capital accounts;
- government expenditure or borrowing can be shifted 'off-budget'; and
- the cash accounting basis of fiscal reports does not fully disclose the long term fiscal impact of current decisions.

3.194 The Committee also observes that the fiscal information that is published in Australia is spread around in different publications, for different timeframes, and prepared by different bodies - instead of being consolidated in the Budget Papers.

3.195 The Committee finds itself in agreement with Ernst & Young, which submitted:

> *While existing reporting mechanisms through such channels as budgetary papers, including forward estimates and economic outlook statements, already provide substantial economic and fiscal information, it is arguable that information is not necessarily presented in a way that best promotes transparency to the public of Government fiscal planning intentions and provides a sufficiently systematic base for monitoring Government performance against explicit benchmarks and plans.*[119]

117 Paras 3.145 to 3.152 above.

118 See Appendix IV.

119 Ernst and Young, *Submission*, p. S173.

3.196 Despite the criticisms levelled at the Commonwealth's fiscal reports, the Treasury did not indicate to the Committee that there are any plans for a major review or upgrade of the Commonwealth's fiscal reporting regime.

3.197 Indeed the Treasury considered that the Budget Papers already contained more information than readers wanted and that 'it is hard to see what systematic proposals there are to improve them [the Budget Papers] when they are being reported on the current basis'.[120]

3.198 The Treasury may be right that the Budget Papers cannot be improved in a cash reporting environment. However, the Committee does not consider it appropriate for Australia's fiscal reports to continue to be cash based.

3.199 The Committee considers it is the role of parliament to specify the form and content of financial reporting that will best enable it to fulfil its obligations in relation to fiscal decision making and holding the government to account for fiscal policy.

3.200 The Committee considers financial reporting for the Commonwealth would be enhanced if the parliament were to set standards for financial reporting for the Commonwealth. In particular, these might include a legislative reporting framework incorporating accrual accounting, accrual reporting and accrual budgeting.

3.201 Fiscal reporting legislation is the obvious effective vehicle for the parliament to specify reporting standards for the Commonwealth budget cycle. The *Financial Management and Accountability Bill 1995* already provides a legislative framework for the preparation of whole of government reports as part of the accountability cycle of government financial reporting.

120 Bruce Taplin, the Treasury, *Transcript*, p. 137 (Canberra, 4 October 1995). Finance and the Treasury indicated that there is a wealth of special purpose financial information available to the government and to policy advisers but not published in general purpose financial reports. For example, the Treasury prepares measures of the underlying deficit netting out the impact of asset sales.

3.202 Improved fiscal reporting was the single issue in this inquiry on which most contributors agreed. As one submission observed, 'It is impossible to disagree with a form of Fiscal Responsibility Legislation which increases the quantity and quality of publicly available information about the activities of government'.[121]

Conclusion on the need for fiscal reporting legislation for the Commonwealth

3.203 It follows from the above analysis that the Committee believes that fiscal reporting legislation for the Commonwealth would be desirable to help ensure the release of more and better fiscal information to the public.

Criticisms of fiscal responsibility legislation

3.204 In recommending the appropriate fiscal responsibility legislation for the Commonwealth, the Committee has addressed the following criticisms:

- that it is impossible to set **fiscal targets or fiscal principles** that would be generally agreed and enforceable;
- that implementing the public reporting requirements of fiscal responsibility legislation would result in **additional costs** to the Commonwealth;
- that fiscal responsibility legislation for the Commonwealth is complicated by the financial relationship between **the Commonwealth and the States;**
- that there is a risk that fiscal responsibility legislation will encourage **'creative accounting'** whereby governments manipulate the format and content of financial reports to give the appearance of compliance with fiscal responsibility legislation;

121 Professor Brian Andrew and Ms Cecilia Spence, School of Accounting and Finance, University of Canberra, *Submission*, p. S125.

- that there is a risk that fiscal responsibility legislation could **inhibit or distort discretionary fiscal policy**;
- that there is a risk that public attention could become focused on the **'bottom line'** of the government's financial performance with a corresponding lack of attention to the government's effectiveness in delivering services.

3.205 Each of these criticisms is discussed below.

Fiscal targets

3.206 The most serious concern about fiscal responsibility legislation raised in evidence to this inquiry was in relation to the setting of specific fiscal targets.

3.207 The Treasury proposed a range of specific fiscal targets that could be used as benchmarks for fiscal performance, namely:

- *achievement of specific budget balances on a specified time frame*
- *achievement of some average budget balance over the economic cycle*
- *maintenance or pursuit of a particular structural balance in the budget*
- *following the 'golden rule', ie limiting current outlays to current receipts ...*
- *achieving particular targets for government debt or government net worth*
- *commitments in respect of taxation levels or rates*
- *commitments in respect of levels or rate of growth of outlays*
- *achievement of a certain rate of government saving.*[122]

122 The Treasury, *Submission*, p. S96.

3.208 Of course, other jurisdictions have attempted to enforce certain of these fiscal targets with limited success, as outlined earlier. The overseas experience shows that fiscal targets encourage creative accounting and/or inhibit the ability of the government to implement discretionary fiscal policies.

3.209 The two major arguments advanced against fiscal targets in evidence to this inquiry were:

- that there was highly unlikely to be agreement on appropriate fiscal targets for the Commonwealth;[123] and
- that it would be impossible to enforce a fiscal rule upon government.[124]

3.210 The Committee does not support statutory fiscal targets. Fiscal targets belong to the cash accounting environment, which the Committee has already argued is inappropriate for the Commonwealth.

Fiscal principles for the Commonwealth

3.211 Whilst the idea of fiscal targets for the Commonwealth was not widely favoured, there was considerable support for legislating binding fiscal principles and also considerable commonality of view as to what those principles should be for the Commonwealth.

3.212 A key feature of the Fiscal Responsibility Act (NZ) is the enshrinement in legislation of five principles of fiscal responsibility.[125] The Committee announced early in the inquiry that it would consider if these were appropriate principles for the Commonwealth of Australia.

123 The NSW Auditor-General was a strong proponent of this view. *Submission*, pp. S71-72.

124 Professor Marc Robinson presented a compelling critique of fiscal targets and the impossibility of their enforcement. *Submission*, pp. S52-60.

125 See para 3.130 above.

3.213 Dr Graeme Wells considered the New Zealand principles to be internally inconsistent.[126] Dr Wells considered the New Zealanders themselves might not include fiscal principles if they were framing the legislation again.[127]

3.214 Ernst & Young considered that New Zealand's five principles could effectively be consolidated into four and that the adoption of these principles by the Commonwealth would 'provide increased assurance to the investing and borrowing public that the Commonwealth is committed to a predictable and stable tax regime into the long term'.[128] The four principles proposed were:

- *maintaining Commonwealth Government debt at prudent levels;*
- *maintaining acceptable levels of Commonwealth net worth;*
- *managing prudently the fiscal risks facing the Commonwealth; and*
- *pursuing policies that are consistent with predictability about the level and stability of tax rates for future years.*[129]

3.215 Dr Louise Kloot did not consider the fiscal principles in the New Zealand legislation to be appropriate for the Commonwealth because they are 'goal-oriented', whereas, in her model of fiscal responsibility legislation

> *... it would be preferable to consider legislation that is relatively neutral as to ends ... merely prescribing acceptable methods for recording, classifying and summarising transactions and events, together with disclosure requirements.*[130]

126 New Zealand's fiscal responsibility legislation has, as two of its key principles, that the operating statement should be balanced over time and that debt should be maintained at prudent levels. Dr Wells observed that if interest rates exceed growth rates over time, then the New Zealand government may have to run deficits to hold debt levels steady. *Submission*, p. S235.

127 Dr Graeme Wells, *Transcript*, pp. 156-57 (Canberra, 19 October 1995).

128 Ernst & Young, *Submission*, p. S174.

129 Ernst & Young, *Submission*, p. S174.

130 Dr Louise Kloot, *Submission*, p. S6.

3.216 Dr Kloot considered that a government was fiscally responsible if it 'can deliver [its] electoral promises within the forecast costs, if [it] can achieve the budgeted benefits at the estimated price, and the community is as well off at the end as it was at the beginning'.[131] Dr Kloot considered that the public would make this judgement themselves and that the role of fiscal responsibility legislation was to provide the information for the public to make an informed judgement.

3.217 The Auditor-General of Western Australia saw fiscal responsibility in terms of:

- *not burdening the public with excessive taxation and establishing fairness and equity in the taxation regime;*
- *matching the recurrent spending with taxation revenue thus avoiding mounting debts from accumulated budget deficits;*
- *ensuring long term liabilities, such as employees superannuation are properly funded; and*
- *maintaining the public debt at reasonable levels.*[132]

3.218 It was proposed that such fiscal principles would be specified in fiscal responsibility legislation to 'set the parameters for accountability and reporting'.[133]

3.219 Mr Ian McAuley, Faculty of Management, University of Canberra, considered there would be general agreement that 'governments should not spend more than they raise in taxes and other revenue [and that] they should not burden future taxpayers with today's extravagance'.[134]

131 Dr Louise Kloot, *Submission*, p. S4.

132 D D R Pearson, Auditor General of Western Australia, *Submission*, p. S29.

133 D D R Pearson, Auditor General of Western Australia, *Submission*, p. S29.

134 Ian McAuley, *Submission*, p. S45.

3.220 The Treasury considered responsible fiscal policy would exhibit the following characteristics:

- *it will seek balance in treatment across generations, that is, it will exhibit inter-generational equity and avoid excessive net expenditure on the current generation at the expense of future generations;*
- *it will recognise the cyclical nature of the economy and have regard to the scope for smoothing the peaks and troughs of the business cycle, even if only through the operation of the 'automatic stabilisers';*
- *it will make an adequate contribution to national savings needed to fund investment; and*
- *similarly, it will maintain government programs at levels that have regard to the burden placed on taxpayers in funding them and the unavoidable efficiency costs of taxation.*[135]

3.221 It is obvious from the above summary of views on fiscal principles that there is general agreement about the concept and meaning of fiscal responsibility, notwithstanding it may be difficult to pin fiscal responsibility down to a definition or to specific targets. The two major common principles are that, over time, the government shouldn't spend more than it earns, and that, as a general principle, borrowing should be used for investment so that future taxpayers reap the benefits of the debts they will have to amortise.

3.222 The Committee is encouraged by the evident broad agreement to believe that economic commentators, and the public, will have little difficulty assessing the performance of government if they are given enough fiscal information to do so. The problem with fiscal reports in the past is that they have obscured the long term consequences of policy decisions so that intergenerational equity issues have not arisen and, furthermore, they have muddled the current and capital accounts so that it has not necessarily been immediately obvious if a government was living beyond its means.

3.223 The Committee considers that the publication of whole of government reports on an accrual basis will assist to correct many of these perceptional problems.

135 The Treasury, *Submission*, pp. S95-96

3.224 However, the Committee does not see a need to formulate binding statutory principles of fiscal responsibility. In any case, such fiscal principles would be so imprecise and so wide open to interpretation that there seems little point prescribing them in legislation. The Committee is also wary of the idea that there are enduring fiscal principles.

Cost of fiscal responsibility legislation

3.225 The cost of fiscal responsibility legislation in financial terms will be the additional administrative cost that could be incurred through the reporting requirements of the legislation.

3.226 Obviously, accurate costs of implementing fiscal responsibility legislation for the Commonwealth cannot be estimated before the specific requirements of the legislation have been drafted.

3.227 However, there would no doubt be a cost. Finance advised:

> *The preparation of material for publication always imposes an additional workload. That is simply the nature of the quality control and presentational work that you need to do to make sure that figures are properly explained and understood.*[136]

136 Steve Sedgwick, Finance, *Transcript*, p. 10 (Canberra, 8 September 1995).

3.228 The Committee considers that the administrative costs of fiscal responsibility legislation for the Commonwealth should be minimal for the following reasons:

- the government already prepares and publishes fiscal information at a cost;
- information systems are in place to produce and publish fiscal reports; government departments are already resourced to produced fiscal reports; fiscal responsibility legislation should result in a reallocation or redirection of resources but not an overall increase;
- any additional reports recommended by the Committee should have an incremental cost since they do not involve additional collections of financial information but merely updates or revised presentations;
- major changes to the form and content of the Budget Papers to bring them into an accrual environment will involve a necessary one-off cost but this must happen eventually, even without fiscal responsibility legislation.

Commonwealth/State financial relationship

3.229 Asked about the effect on fiscal responsibility legislation of the financial relationship between the Commonwealth and the States in Australia, the Deputy Secretary for Fiscal Policy, Treasury advised:

I do not think I have ever seen anything else in government that was not complicated by the federal system, so it would be surprising if this were not.[137]

137 Rod Shogren, the Treasury, *Transcript*, p. 23 (Canberra, 8 September 1995).

3.230 The immediately apparent complications of the federal system for fiscal responsibility legislation are that:

- the Commonwealth could achieve any fiscal objective promoted in fiscal responsibility legislation by shifting 'fiscal pain' to the States - that is, by cutting Commonwealth/State payments rather than cutting Commonwealth programs;[138]
- the Commonwealth's net worth to be included in fiscal reports will not incorporate State owned assets funded by the Commonwealth and, to this extent, fiscal reports would present a less than accurate picture of the Commonwealth's investment in infrastructure;[139] and
- since such a high proportion of Commonwealth revenue ends up in the State coffers, it would be less than satisfactory if enhanced reporting requirements laid down in fiscal responsibility legislation for the Commonwealth were not matched by better disclosure of the disbursement of Commonwealth funds in the financial statements of States and Territories.

3.231 However, these difficulties should not be overstated. On this point, Ernst & Young suggested that,

There may be a case for the Commonwealth seeking to consult with the States (and local Governments) to jointly explore the desirability and practicability of comparable fiscal responsibility legislation being adopted by each legislature.[140]

138 Professor Marc Robinson argued that this is 'likelihood rather than possibility' and that many would argue that 'this is precisely what the Commonwealth did in the 1980s to produce its much-vaunted budget surpluses'. *Submission*, p. S55. Professor Robinson went on to explain that this problem could be overcome by constitutional guarantees of revenue-sharing, '... an outcome, although highly desirable, for which one would not be well advised to hold one's breath'. *Submission*, p. S56.

139 The Treasury, *Submission*, p. S117. This issue is treated in detail in Chapter 2 of this report. It is true that State infrastructure funded by the Commonwealth will not appear as 'assets' in Commonwealth whole of government reports. However, details of Commonwealth payments to the States can be included in accompanying notes.

140 Ernst & Young, *Submission*, p. S174.

3.232 The Committee notes that all States and Territories are negotiating on common accounting standards and an implementation timetable for whole of government reporting,[141] that NSW proposes to adopt fiscal responsibility legislation, and that all States and Territories in Australia have in place medium term fiscal strategies.[142]

3.233 In practice, all jurisdictions in Australia are heading down the same path - recognising and responding to the push for accrual based financial reporting systems and whole of government reporting, recognising and responding to the need for stable fiscal policy to maintain credibility in the financial markets.

3.234 The Committee believes the Commonwealth should take the lead in these matters.

Creative accounting

3.235 When governments are bound to achieve specific fiscal targets, there is an incentive for 'creative accounting' whereby reporting standards and budget figures are manipulated to yield the desired results.

3.236 Creative accounting techniques include:

- using government trading enterprises as 'cash cows';
- reclassifying current expenditure as capital expenditure;
- shifting capital expenditure off-budget into private sector enterprises guaranteed by the government;
- creative treatment of depreciation;
- asset sales;
- sales of future revenue streams;
- sale and leaseback of government assets;
- shifting expenditure and revenue between financial years to improve the cash balance in a particular year at the expense of future years.

141 See Appendix IV.

142 The Treasury, *Submission*, pp. S111-13.

3.237 Real examples of 'creative accounting' by governments were given earlier in this chapter in relation to the United States experience with specific fiscal targets and constraints.

3.238 The problem of creative accounting is chiefly applicable to legislation that mandates fiscal targets. It is far less relevant to fiscal responsibility legislation that relies on transparent reporting. It is also an issue that has arisen in a cash accounting environment. It will apply to a far lesser degree to fiscal reports prepared for the whole of government reporting entity on an accrual basis.

3.239 The preparation of whole of government reports as recommended by the Committee[143] would preclude most forms of 'creative accounting' that have been used in the cash accounting environment to manipulate the budget deficit and/or debt levels.

3.240 Accrual accounts are, of course, prone to their own forms of 'creative accounting' - such as manipulation of asset valuations and application of questionable rates of depreciation. However, accounting standards can address these problems to a significant degree.

Discretionary fiscal policy

3.241 It has been argued that fiscal responsibility legislation is more appropriate for the State and Territory governments in Australia - which are principally responsible for service delivery, but less appropriate for the Commonwealth government - which is responsible for counter-cyclical macroeconomic policy.

3.242 Fiscal responsibility legislation, it is argued, could introduce inflexibility into fiscal policy, impeding the use of fiscal stimulus in a recession or fiscal stringency to counter inflationary pressures.

143 The Committee's conclusions and recommendations on whole of government reporting for the Commonwealth appear in Chapter 2 of this report.

3.243 The Secretary of the NSW Treasury, giving evidence about the fiscal responsibility legislation proposed for that State, observed:

> *In terms of applicability to the Commonwealth, generally I would say it is applicable, although you need to recognise that, with a national government, there is a macroeconomic responsibility which is not pertinent to a state government. The philosophy behind this is very much that the state government does not have a macroeconomic responsibility. It has responsibility for sound finances and delivery of services but it has not macroeconomic responsibility. That is relevant, in thinking about the legislation.* ***It really only affects the issue of fiscal targets. It does not affect the other aspects of the legislation.***[144] [emphasis added]

3.244 The Committee agrees that the criticism of 'inflexibility' applies to fiscal responsibility legislation that commits governments to specific targets - such as balanced budget legislation - but not at all to fiscal responsibility legislation that relies on transparent reporting requirements. In the latter scenario, governments can undertake whatever fiscal policy they consider appropriate to the extent that they can 'sell' this policy to the electorate.

3.245 In fact, improved fiscal reporting on a whole of government accrual basis could enhance the Commonwealth's economic management. Finance submitted that there were inherent links between the Commonwealth's financial position, as shown in whole of government reports, and economic management since:

> *... the Commonwealth's capacity to acquit its economic management role depends, in part, on the strength over time of its financial position. Whole of government reports, properly interpreted, could provide input to the management of the Commonwealth's financial position in this respect.*[145]

144 NSW Treasury, *Submission*, p. S212.

145 Finance, *Submission*, p. S262.

Focus on 'the bottom line'

3.246 The purpose of fiscal responsibility legislation is to ensure the transparency of the government's financial performance.

3.247 The concern is that fiscal responsibility legislation will focus so much attention on financial indicators such as 'net worth' and 'net debt' that more important, but not easily quantifiable, indicators of the government's performance will be largely ignored.

3.248 Steve Sedgwick, Secretary of the Department of Finance, stressed that a policy focus on the Commonwealth's 'net worth' would provide incentives for behaviour that would register in reports as 'fiscally responsible' but could in fact be inappropriate or distortionary. He posed the question:

> *... 'What are the incentives that you provide if you measure things in a certain way or collect certain pieces of information and publish them?' One of my concerns is that if we end up with an excessive emphasis on net worth as a headline indicator, we will tend to encourage behaviour designed to manage that headline rather than necessarily do things which are sensible in any long-term financial management sense. ...*
>
> *I think what you need to do is ask yourself what behaviour you encourage if the talisman of success is an increase in net worth. The behaviour that you encourage is to fund assets out of revenue and to try to convert your expenses into assets whenever possible.*[146]

146 Steve Sedgwick, Finance, *Transcript*, p. 177 (Canberra, 20 October 1995).

> *... It may be different if you are dealing with an organisation whose business is dominated by the management of assets - hospitals, schools and stuff - than if your business is dominated by the payment of transfer payments to unemployed people and Austudy and sickness benefits and child-care payments and all the rest of it, which are not assets based; they are recurrent expenditure.*[147]

3.249 The Commonwealth Government is not a profit maximising corporation. Its performance is not only to be judged in financial terms. It is arguable that it would be more appropriate for Commonwealth government policy to be judged on the basis of its impact on employment generation, patterns of income distribution across Australian society, effectiveness of program delivery and so on.

3.250 If and when whole of government reports are published in Australia, there will be a need for education, interpretation and informed debate on the meaning of the resulting measures of government performance. All statistics have the potential to be misunderstood by the public and to be deliberately misused by commentators. This is not an argument for not preparing fiscal reports, but an argument for careful launching of the early reports.

Conclusion

3.251 The Committee has been mindful to address the concerns outlined above in developing its model of fiscal reporting legislation for the Commonwealth.

Desirable features of fiscal reporting legislation for the Commonwealth

3.252 The Committee does not support **fiscal responsibility legislation** for the Commonwealth if it attempts to define 'prudent' fiscal behaviour or if it requires governments to adopt fiscal strategies in conformity with pre-determined fiscal targets or principles.

147 Steve Sedgwick, Finance, *Transcript*, p. 170 (Canberra, 20 October 1995).

3.253 However, the Committee considers that the case for **fiscal reporting legislation** is compelling.

3.254 Fiscal reporting legislation provides a framework for governments to be accountable to the public for their management of the nation's finances.

3.255 Fiscal reporting legislation can be the vehicle in which the parliament sets down the form, content and frequency of reporting that it considers necessary.

3.256 The Committee has considered the type of fiscal reporting model that would be appropriate for the Commonwealth. This model is outlined below.

Fiscal reporting requirements in an accrual culture

3.257 The Committee strongly believes that the Commonwealth should embrace an accrual accounting regime.

3.258 An integrated accounting/reporting/budgeting model for the Commonwealth would incorporate accrual accounting and reporting in government agencies, the preparation of forward estimates on an accrual basis, the consolidation of accrual information into a whole of government report for the Commonwealth, and accrual budgeting at the whole of government level.

3.259 The Committee's conviction that future financial reporting for the Commonwealth should be on an accrual basis underpins its recommendations on the form of fiscal reports that could be required by legislation.

Whole of government reporting

3.260 As discussed in Chapter 2, whole of government reporting on an accrual basis for the Commonwealth promises enhanced accountability of the government to parliament and to the electorate. The major enhancements to accountability offered by whole of government reporting on an accrual basis are:

- the inclusion on the government balance sheet of all major government agencies - including government business enterprises - so that government borrowing or other financial commitments cannot be 'off-budget';
- the separation of capital and current accounts so that asset sales cannot be disguised as revenue to be used to fund recurrent spending;
- the disclosure of the government's net worth as an indicator of whether the government is running down the nation's asset base or investing in assets for the benefit of future generations; and
- the disclosure of the long run costs of policy decisions **at the time those decisions are taken** so that governments do not run up excessive unfunded liabilities - such as unfunded superannuation commitments.

3.261 The potential of whole of government reporting on an accrual basis will not be realised in the absence of legislation requiring the preparation and tabling of these reports as an integral part of the budget cycle.

3.262 Accordingly, the Committee's model of fiscal reporting legislation for the Commonwealth mandates the preparation and publication of whole of government accrual reports in substitution for the existing cash based financial statements of government.

Fiscal indicators

3.263 The Committee has rejected the idea of legislating fiscal targets or fiscal principles. However, the Committee considers there is a strong argument for specifying in any fiscal reporting legislation the key indicators against which governments must report and against which the performance of government is best assessed.

3.264 Dr Graeme Wells submitted that the most important indicator of the government's financial performance would be net debt as a proportion of GDP.[148]

3.265 However, others considered that there was already an ill-advised focus on reducing or eliminating debt, with insufficient consideration being given to the social benefits of investment in infrastructure funded by debt.[149]

3.266 It was argued that 'net worth' is a better indicator of fiscal responsibility because net worth will be increased by productive investment, but adversely affected if debt is incurred for recurrent spending.[150] However, net worth can change from year to year even in the absence of policy change - because it is an indicator vulnerable to changes in interest rates, for example.[151]

3.267 The Committee does not consider that any one measure of financial performance will tell the whole story. The Committee recommends that a brace of fiscal indicators be identified, each revealing a different aspect of the financial position of the Commonwealth. These indicators would include both net debt and net worth. Other indicators likely to be of interest to the public would include:

- operating deficit/surplus;
- increase/decrease in taxation revenue as a percentage of GDP;
- increase/decrease in expenditure as a percentage of GDP.

148 Dr Graeme Wells, *Submission*, p. S238.

149 Tony Harris, NSW Auditor-General, *Submission*, p. S71, and John Quiggan, *Submission*, p. S139.

150 John Quiggan, *Submission*, pp. S139-40.

151 The Treasury, *Submission*, p. S116.

3.268 Finance cautioned against excessive reliance on a single or headline measure such as net worth[152] and emphasised the need for a range of performance indicators which could be addressed consistently from year to year.[153]

3.269 The Committee considers it would be desirable to specify indicators of fiscal performance - but not goals or principles - to enhance fiscal reporting. If successive governments are reporting against agreed criteria, it will be easier to assess fiscal performance over time.

3.270 As discussed in Chapter 2, the Committee considers it would be the responsibility of Finance and the Treasury to advise the government on the appropriate indicators and to prepare notes to assist interpretation of the indicators.

Forecasts and outlooks

3.271 The Committee believes it is important for the Budget Papers to look beyond the four year timeframe presently underpinned by the forward estimates of departments.

3.272 It is highly desirable that fiscal strategists, fiscal commentators and the public generally focus on the long term future direction of the Australian economy and on the long term financial commitments of the Commonwealth - not just on the impact of fiscal policies within the electoral cycle.

3.273 Although governments have discretion to affect fiscal outcomes at the edges, a substantial proportion of government expenditure represents quasi-contractual commitments between the government and the electorate. Much of the social security budget would fall into this category. It is possible to project such expenditures into the future and, the Committee would argue, useful.

152 Steve Sedgwick, Finance, *Transcript*, p. 161 (Canberra, 20 October 1995).

153 Dean Wallace, Finance, *Transcript*, p. 176 (Canberra, 20 October 1995).

3.274 The Governor of the Reserve Bank, Mr Bernie Fraser, submitted that:

> *One area where additional information could be highly relevant to more informed decision making - though its reliability would be heavily qualified - is in respect of the distribution of fiscal burdens over an extended time horizon. That is, the question of how the burgeoning costs of pensions and certain other 'entitlements' are to be shared among current and future generations. In my view, efforts to devise useable estimates of these inter-generational consequences of major policy decisions are likely to be more relevant and productive than efforts to devise measures to control the deficit.*[154]

3.275 However, while the Committee would like to see more economic and fiscal projections in the Budget Papers, it also recognises that such information will be, of its nature, less reliable the further into the future it reaches.

3.276 Accordingly, the Committee is proposing that forecasts or projections be provided for the budget year and the next four years. The economic forecasts underpinning the fiscal estimates should also be published for this timeframe.

Budget Papers

3.277 There is presently no legal requirement for all the Budget Statements to be tabled in the parliament and thus the form and content of a major annual report on the Commonwealth's financial position is at the discretion of governments and their advisers.

3.278 The Committee believes that the parliament should identify the information it requires to be published in the Budget Statements.

154 B W Fraser, Governor, Reserve Bank of Australia, *Submission*, p. S183.

3.279 Accordingly, the Committee recommends that fiscal reporting legislation for the Commonwealth should mandate the tabling of:

- Budget Papers;
- mid-year update of the budget estimates; and
- the Actual Budget Outcome.

3.280 The Committee also considers that the legislation should provide for:

- a condensed version of the Budget Papers; and
- the publication of a pre-budget fiscal strategy statement.

3.281 Most of the above reports the Committee would see laid down in fiscal reporting legislation already have some parallel report in the existing cash reporting system.

3.282 However, Australian does not have a requirement for the tabling or publication of a condensed version of the Budget Papers or a pre-budget report.

Condensed Budget Papers

3.283 The Budget Papers published by the Commonwealth are voluminous, containing much detailed information that is not readily understood by the general public. It is understandable that many people rely on commentaries provided by the media or summaries prepared by economic consultants.

3.284 The Committee believes that governments - not external parties - should take responsibility for making available to, and for, the general public, information on governments' financial positions and fiscal policies.

3.285 Accordingly, the Committee proposes the publication of condensed Budget Papers to enhance transparency of the government's fiscal strategies so that an educated and informed public can hold its elected representatives to account.

3.286 A model for the condensed Budget Papers could be the *Annual Financial Report of the Government of Canada.* This report is based on the Canadian Public Accounts, not budget reports. However the format of the report would also be suitable for budget reports.

3.287 The *Annual Financial Report of the Government of Canada* for the 1993-94 fiscal year[155] was a 33 page document, making extensive use of tables and graphs and dot-point summaries. The report included condensed whole of government reports and condensed versions of the Public Accounts and National Accounts of Canada, together with commentaries on the financial position of the government and the state of the economy.

3.288 The Committee considers that the availability to the public of accurate and easily absorbed information about the activities of government is an essential component of a fiscal reporting regime.

Pre-budget fiscal strategy statement

3.289 The pre-budget fiscal strategy statement has two immediately apparent attractions.

3.290 First, it makes the government's fiscal policy more transparent prior to the implementation of budget strategies, resulting in less mayhem in financial markets when the budget is tabled.

3.291 Dr Graeme Wells did not see the need for a pre-budget report in Australia. He considered that the details of Australia's recent budgets were generally known in advance.[156] However, he conceded that 'when you want stability in financial markets, I guess you want to avoid surprises'.[157]

155 Minister of Finance (Canada), *Annual Financial Report of the Government of Canada, Fiscal year 1993-94.*

156 Dr Graeme Wells, *Transcript*, pp. 157-58 (Canberra, 19 October 1995).

157 Dr Graeme Wells, *Transcript*, p. 158 (Canberra, 19 October 1995).

3.292 The Treasury agreed that the financial markets **do** respond to fiscal policy statements by governments in Australia. Mr Rod Shogren, Deputy Secretary for Fiscal Policy, the Treasury, gave evidence that:

> *... back at the end of January this year ... the government said that it would implement a significant structural tightening in the budget. What we actually saw then was an improvement in interest rates between that time and the budget. That would indicate to me the markets believed that the government was going to do what it said it would do.* [158]

3.293 The second advantage of the pre-budget report is that, as happens in New Zealand, parliamentary committee review of the report would provide an open forum for public debate on fiscal policy prior to the delivery of the budget.[159]

Parliamentary scrutiny of fiscal performance

3.294 It is proper for the debate about Australia's financial performance and future fiscal policy for Australia to take place on the floor of the House, and in public hearings of parliamentary committees. It is also desirable that the role of the parliament in relation to fiscal policy is not confined to opposing or making piecemeal amendments to the Appropriation Bills.

3.295 In Australia, the estimates and performance of individual Commonwealth agencies are regularly examined by parliamentary committees but not the fiscal performance of the whole Government.

3.296 The Committee considers it would be appropriate for each fiscal report published pursuant to fiscal reporting legislation to stand referred to a parliamentary committee established for that purpose, for inquiry and report.

3.297 The Treasury submitted that there is presently ample opportunity for public input into the budgetary process

158 Rod Shogren, the Treasury, *Transcript*, p. 22 (Canberra, 8 September 1995).

159 Dr Graeme Wells was not convinced that the costs of a pre-budget statement would be justified in Australia. However he supported scrutiny of the budget projections by a parliamentary committee. *Transcript*, p. 157 (Canberra, 19 October 1995).

through submissions to the Economic Planning and Advisory Council (EPAC).[160]

3.298 However, the role of EPAC is solely advisory. The government need not heed any views or recommendations put forward in this forum.

3.299 The advantages offered by parliamentary committee review (over the existing budget consultation process coordinated by EPAC) include the following:

- the parliamentary committee inquiry, by its very nature, would be public; interested parties would be able to do far more than make submissions - they could attend public hearings as witnesses or observers and provide a critique of other evidence;
- the parliamentary committee could be empowered to call government ministers to give evidence on matters relevant to their portfolio responsibilities; and
- the Committee's report would be tabled and debated in the parliament and governments would be obliged to reply to any recommendations.

3.300 The Committee believes that, while governments must always have the final say about fiscal strategies and policies, there is a wealth of knowledge and expertise in the community that should be brought to bear in the budget process. *The Committee considers it likely that interested* parties would be more willing to provide input to the budgetary process direct to the parliament (through one of its committees) than through a government advisory body.

Conclusions and recommendations

3.301 The Committee supports the enactment by the Commonwealth of **fiscal reporting legislation,** in clear distinction to fiscal responsibility legislation.

3.302 In the model of fiscal responsibility legislation envisaged by the Committee, the transparency of fiscal reports - and the informed debate these reports will generate - will be

160 The Treasury, *Submission*, p. S280.

the real discipline on the fiscal performance of the government of the day.

3.303 The Committee sees fiscal reporting legislation as a vehicle for the Parliament of the Commonwealth of Australia to lay down its fiscal reporting requirements. This is an opportunity for the Commonwealth to enact the legislative framework for an integrated fiscal reporting model based on accrual accounting, whole of government reporting and accrual budgeting.

3.304 Although the Committee makes specific recommendations about the form and content of fiscal reports for the Commonwealth, the Committee has become concerned in its current inquiry that very few people or organisations in Australia have turned their minds to fiscal reporting.

3.305 For this reason, the Committee is concerned that there be a further opportunity for public input into the development of fiscal reporting legislation for the Commonwealth. The Committee considers that, to this end, the proposed fiscal reporting legislation should be referred to the Joint Committee of Public Accounts for inquiry and report, following its introduction into the parliament. The Committee is of the view that there will be considerably more public interest once the specifics of any such legislation are known.

Recommendations

Fiscal reporting legislation for the Commonwealth

3.306 **Recommendation 12**

The Government should prepare and introduce into Parliament legislation to establish a fiscal reporting framework binding on Commonwealth governments, such legislation to be called the Fiscal Reporting Act.

Fiscal reports to be prepared on an accrual basis

3.307 **Recommendation 13**

The proposed Fiscal Reporting Act should require:

(a) that fiscal reports be prepared in the form of whole of government reports on an accrual basis; and

(b) that the form and content of fiscal reports for the Commonwealth accord with the Committee's recommendations in Chapter 2 of this report.

Accrual budgeting for the Commonwealth

3.308 **Recommendation 14**

The proposed Fiscal Reporting Act should require:

(a) that the Commonwealth adopt accrual budgeting following the tabling of the first audited whole of government reports for the Commonwealth; and

(b) that the first accrual budget for the Commonwealth be introduced into Parliament for the 1999-2000 financial year.

Fiscal reporting requirements - form and content

3.309 **Recommendation 15**

The proposed Fiscal Reporting Act should require the tabling or publication of fiscal reports of specified format, as follows:

(a) that an agreed set of indicators of a government's financial performance - including net debt[161] as a proportion of GDP - be specified in the legislation;

(b) that governments be required to report against these indicators their achievements and future policies in each report required under the legislation;

(c) that fiscal reports incorporate estimates for the budget year and the following four years of all major fiscal variables (such as net debt);

(d) that the fiscal reports specify the macroeconomic assumptions on which estimates are based;

(e) that fiscal reports incorporate forecasts or projections for the budget year and the following four years of all appropriate economic indicators on which fiscal estimates are based;

(f) that fiscal reports contain a statement of sensitivity of fiscal estimates to economic conditions; and

(g) that the format and content of the fiscal reports prepared under this Act remain constant over time to allow historical comparisons.

161 Net debt equals financial liabilities less financial assets. Net debt can be calculated for the public sector as a whole (including GBEs) with breakdowns for different government sectors (GBEs, budget sector).

Fiscal reporting requirements - budget cycle

3.310 **Recommendation 16**

The proposed Fiscal Reporting Act should require the tabling or publication of fiscal reports in accordance with a mandatory reporting cycle, as follows:

(a) that governments be required to table a statement three calendar months prior to the day on which the Budget is introduced into the Parliament stating their Fiscal Strategy for the coming financial year and the next two years;

(b) that, on the day the Budget is tabled in Parliament, the Treasurer table a statement specifying how the Budget conforms with the Fiscal Strategy;

(c) that, on the day the Budget is tabled in Parliament, the Treasurer table Budget Papers;

(d) that the Budget Papers contain the following information:

- ***the Commonwealth operating statement, including estimates for the budget year and the following four years;***
- ***the financial position of the Commonwealth including estimates for the budget year and the following four years;***
- ***the statement of cash flows for the Commonwealth, including estimates for the budget year and the following four years;***
- ***notes to the financial statements including information about contingent liabilities, restricted financial assets and capital expenditure commitments;***
- ***statement of borrowings and other financial commitments; and***

- *accrual based forward estimates of each government agency funded from Consolidated Revenue;*

(e) *that the operating statement, statement of financial position and statement of cash flows for the Commonwealth, including forward estimates, be updated and published midway through the financial year; and*

(f) *that actual budget outcomes and audited whole of government financial statements be published as soon as they are available.*

Fiscal reporting requirements - condensed Budget Papers

3.311 Recommendation 17

The proposed Fiscal Reporting Act should provide that the Treasury prepare a condensed version of the Budget Papers, to be tabled with the Budget Papers, in a format which is accessible to the general public and which includes a commentary explaining the meaning of the budget figures to lay readers unfamiliar with economic concepts or accounting terminology.

Parliamentary scrutiny

3.312 Recommendation 18

The proposed Fiscal Reporting Act should establish a joint committee of Parliament to examine and report on fiscal reports produced pursuant to the legislation. All fiscal reports would automatically stand referred to this committee for inquiry and report.

The Act should make specific provision for the committee to call relevant Ministers of State to give evidence.

Review of Fiscal Reporting Bill

3.313 Recommendation 19

The proposed Fiscal Reporting Bill should be referred to the Joint Committee of Public Accounts following its tabling in the House, for inquiry and report.

Consultation with States and Territories

3.314 Recommendation 20

The Department of Finance and the Treasury should commence discussions in the Heads of Treasuries forum with a view to identifying technical and procedural issues that would need to be addressed prior to encouraging the adoption by all Australian States and Territories of mirror fiscal reporting legislation.

Les Scott MP
Chairman

22 November 1995

I

APPENDIX I - SUBMISSIONS

Submissions

1 Institute of Public Affairs

2. Dr Louise Kloot, Senior Lecturer in Accounting, Swinburne University of Technology

3. Public Sector Accounting Standards Board of the Australian Accounting Research Foundation

4. Northern Territory Auditor-General's Office

5. Auditor General of Western Australia

6. Auditor-General, Australian National Audit Office.

7. Mr Ian McAuley, Faculty of Management, University of Canberra

8. Professor Marc Robinson, Queensland University of Technology

9. Australian Statistician, Australian Bureau of Statistics

10. New South Wales Auditor-General

11. New South Wales Auditor-General

12. *Department of Finance*

13. The Treasury

14. Professor Brian Andrew and Ms Cecilia Spence, School of Accounting and Finance, University of Canberra

15. Mr John Quiggan, Department of Economics, James Cook University

16. Business Council of Australia

17. Coopers & Lybrand

18. Professor R G Walker, School of Accounting, University of New South Wales

19. Ernst & Young

20. Auditor-General, Queensland Audit Office

21. Reserve Bank of Australia

22 Premier of Tasmania

23 The Treasury

24 Public Sector Accounting Standards Board of the Australian Accounting Research Foundation

25 The Treasury, New South Wales

26 Department of Administrative Services

27 Dr Graeme Wells, Department of Economics, Australian National University

28 Department of Treasury and Finance, Tasmania

29 Department of Finance

30 The Treasury

31 Northern Territory Treasury

32 Department of Finance

33 Public Sector Accounting Standards Board of the *Australian Accounting Research Foundation*

II

APPENDIX II - EXHIBITS

Exhibits

1. Australian National Audit Office, Submission to the Australian Accounting Research Foundation on ED 62.

2. Rt Hon Bill Birch, Minister for Finance (NZ), *Economic and Fiscal Outlook 1995* (1 June 1995).

3 Graham Fortune, High Commissioner for New Zealand, *Informal briefing to the Joint Committee of Public Accounts, 27 July 1995 - The New Zealand Fiscal Responsibility Act, Whole of Government Reporting in New Zealand.*

4. Rt Hon Bill Birch, Minister for Finance (NZ), *Budget and Fiscal Strategy Report 1995* (1 June 1995).

5. Rt Hon Bill Birch, Minister for Finance (NZ), *Financial Statements of the Government of New Zealand*, for the six months ended 31 December 1994.

6. Rt Hon Bill Birch, Minister for Finance (NZ), *Budget Policy Statement 1995* (23 February 1995).

7. Government of Western Australia, *Preliminary Financial Statements - year ended 30 June 1994* (Treasury of Western Australia, June 1995).

8. A C Harris, NSW Auditor-General, *Accrual Accounting and Whole-of-Government Financial Statements*. Speech to the Audit Panel of the Australian Society of CPAs, (18 May 1995).

9. Australian Bureau of Statistics, *Exposure Draft - Introduction of an accruals basis in Government Finance Statistics* (September 1995).

10. Australian Bureau of Statistics, *Government Finance Statistics Australia - Concepts, Sources and Methods* (AGPS, 1994).

11. NSW Treasury, *Comments by NSW Treasury on Exposure Draft ED 62 'Financial Reporting by Governments'.*

12. NSW Treasury, *Draft Policy Guidelines in Accounting for Public/Private Sector Infrastructure Arrangements* (24 July 1995).

13. Audit Office of New South Wales, copy of letter of 28 June 1995 to Australian Accounting Research Foundation in relation to ED 62.

14. Queensland Government, *Queensland - Financial Management Strategy, Improving Financial Management in the Leading State, A Queensland Government Statement on its Financial Management Strategy for 1994-1998* (June 1994).

15. Queensland Government, *Financial Management Strategy Progress Report* (June 1995).

16. Attachment to Submission No. 1. Des Moore, *The Implications of Globalisation for Macroeconomic Policy* (Institute of Public Affairs, 17 May 1995).

17. Attachment to Submission No. 3. Public Sector Accounting Standards Board of the Australian Accounting Research Foundation, *Exposure Draft 62 - Financial Reporting by Governments* (March 1995).

18. Attachment to Submission No. 3. Micallef, Frank et al *Financial Reporting by Governments - Discussion Paper No 21* (Australian Accounting Research Foundation, 1994).

19. Attachment to Submission No. 5. Government of Western Australia, *Preliminary Financial Statements - year ended 30 June 1994* (Treasury of Western Australia, June 1995).

20. Attachment to Submission No. 17. Coopers and Lybrand, copy of letter of 28 August 1995 to the Australian Accounting Research Foundation, providing comments on Exposure Draft 62.

21 Steering Committee on National Performance Monitoring of Government Trading Enterprises, *Guidelines on Accounting Policy for Valuation of Assets of Government Trading Enterprises - using current valuation methods* (October 1994). Report.

22. Steering Committee on National Performance Monitoring of Government Trading Enterprises. *Guidelines on Accounting Policy for Valuation of Assets of Government Trading Enterprises - using current valuation methods* (October 1994). Overview.

23. Department of Finance. Copy of speech given by the Deputy Secretary, Mr Michael Hutchinson, on whole of government reporting at the CPA seminar in Canberra on 9 October 1995.

24. The Treasury. *Final Budget Outcome 1994-95* (August 1995).

25. The Treasury. *Loan Council Reporting Arrangements.* Provided pursuant to an undertaking given at the public hearing on 4 October 1995.

26. The Treasury. Loan Council, *Future Arrangements for Loan Council Monitoring and Reporting* (5 July 1993).

27. The Treasury. Loan Council Secretariat. Press releases and attached financial statements against Loan Council Allocations for the Commonwealth, States and Territories:

- LCS1, 24 November 1994, Loan Council Allocation outcomes 1993-94;
- LCS2, 24 January 1995, September quarter report 1994-95;
- LCS3, 13 April 1995, Annual financial statements as at 30 June 1994;
- LCS4, 13 April 1995, December quarter report 1994-95; and
- LCS5, 16 August 1995, March quarter report 1994 -95.

28. Ruth Richardson [NZ] Ltd. Printout of computer-based audiovisual presentation to the Committee on 26 October 1995.

29. Attachment to Submission No. 30. The Treasury, *Government Securities on Issue at 30 June 1995.*

30. Queensland Treasury, *Recording & Valuation of Non-Current Physical Assets in the Queensland Public Sector* (October 1994).

31. Office of Financial Management, Chief Minister's Department, Australian Capital Territory, *Accrual Accounting in the ACT Public Sector - Review of the Implementation Process* (June 1995). Copy of ED 62 attached.

32. National Association of State Budget Officers (USA), *Budget Processes in the States* (February 1995).

33. National Association of State Budget Officers (USA), *Budget Strategy - A Policy Framework for States* (July 1995).

34. Chancellor of the Exchequer (United Kingdom), *Better Accounting for the Taxpayer's Money - The Government Proposals - Resource Accounting and Budgeting in Government* (29 July 1995).

III

APPENDIX III - WITNESSES AT PUBLIC HEARINGS

Canberra, Friday 8 September 1995

Department of Finance

Mr Stephen Sedgwick
Secretary

Mr Phil Bowen
First Assistant Secretary
Financial Management Division

Mr George Carter
Special Adviser
Accounting

Mr Paul Goodwin
Senior Adviser
Expenditure Policy Branch

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

Department of Treasury

Mr Rodney Shogren
Acting Deputy Secretary
Fiscal

Mr Michael Clark-Lewis
Director
Public Sector Finances Section

Mr Peter Horn
Assistant Secretary
International Economic Policy Branch

Mr David Imber
Director
Budget Revenue Section
Fiscal Policy Division

Mr Bruce Taplin
Assistant Secretary
Public Sector Policy Branch

Australian Bureau of Statistics

Dr Richard Madden
Deputy Australian Statistician

Mr Brian Donaghue
Director
Public Finance Section

Mr Russell Rogers
Assistant Statistician

Mr Frederick Von Reibnitz
First Assistant Statistician
Economic Analysis Division

Australian Accounting Research Foundation

Mr Ian McPhee
Chairman
Public Sector Accounting Standards Board

Mr Frank Micallef
Senior Project Director

Australian National Audit Office

Mr William Nelson
National Business Director
Financial Audit

Mr Russell Chantler
Executive Adviser
Technical Support
Financial Audit Business Unit

Ms Lynne O'Brien
Executive Director
Financial Audit Business Unit

Sydney, Monday 11 September 1995

Auditor-General's Office of New South Wales

Mr Anthony Harris
Auditor -General

Mr Steven Fryer
Senior Audit Manager

Citizen

Professor Robert Walker
School of Accounting
University of New South Wales

Canberra, Wednesday 4 October 1995

Ernst and Young

Mr Geoffrey Applebee
Partner and National Director
Public Sector

Mr Brian Kimball
Senior Manager

Mrs Jenny Morison
Senior Manager

Coopers and Lybrand

Mr Gregor Field
Associate Director

Australian Accounting Research Foundation

Mr Ian McPhee
Chairman
Public Sector Accounting Standards Board

Mr Frank Micallef
Senior Project Director

Department of Treasury

Mr Bruce Taplin
Acting First Assistant Secretary

Mr Michael Clark-Lewis
Acting Assistant Secretary
Public Sector Policy Branch

Mr David Imber
Acting Assistant Secretary
Budget Policy Branch
Fiscal Policy Division

Canberra, Thursday 19 October 1995

Citizen

Dr Graeme Wells
Department of Economics
Australian National University

Canberra, Friday 20 October 1995

Department of Finance

Mr Stephen Sedgwick
Secretary

Mr George Carter
Special Adviser
Accounting

Mr Dean Wallace
Assistant Secretary
Public Administration and Accounting Development Branch

IV

APPENDIX IV

The position of each Australian State and Territory on whole of government reporting

New South Wales

NSW published its first whole of government report in 1989 covering the years 1987-88 and 1988-89. The most recent Consolidated Financial Statements for 1993-94 were released in December 1994. In NSW accrual accounting has been adopted for the Non-Financial Public Sector which includes general government and public trading enterprises. Broadly speaking the NSW Government has adopted the methodology for defining the whole of government reporting entity set out in ED 62.[1] Two areas are still under discussion, namely the issue of local government versus State government control where facilities are funded by the State and controlled by local government, and whether universities are State or Commonwealth controlled.

1 In New South Wales, the 1993-94 Consolidated Financial Statements were performed on a full consolidation basis except for Law Courts Limited, a joint State/Commonwealth government owned entity, and the State Bank of NSW Limited, which were included on a net equity basis.

In the preparation of its whole of government reports NSW fully consolidates all public trading enterprises into the reports as well as core budget sector agencies. Financial and physical assets are valued. Land and buildings, plant and equipment are carried at cost or current value.[2] Infrastructure system assets (eg. roads,[3] bridges) are generally valued at cost or written down replacement cost.

Whole of government accounts are audited although there is no requirement that they be audited. Statements are not tabled in Parliament - however, they are released publically.

Victoria

In Victoria the move from cash based to accrual based reporting by departments is well under way. Accrual based reporting has been adopted with a three year staged introduction which began in 1991-92. All but three departments produced audited accrual based reports for 1994-95. The remaining departments will fully comply with AAS29[4] in 1995-96.

The Government has agreed to the preparation of a trial Consolidated Financial Report of Government for 1994-95, which is scheduled for completion in March 1996. The report will not be subject to audit by the Auditor-General.

The report will only include financial information on bodies controlled by the Government, consistent with the definition of the whole of government reporting entity in ED 62.

2 Refer *Consolidated Financial Statements of New South Wales Public Sector 1993-94*, December 1994, p. 19.

3 Land under roads and within road reserves has not been valued as it presently does not have any alternative feasible use.

4 Australian Accounting Standard No. 29 Public Sector Accounting Standards Board of the Australian Accounting Research Foundation, *Financial Reporting by Government Departments*, (December 1993).

Queensland

The Queensland Government is moving from cash based financial reporting to accrual based reporting in accordance with Australian Accounting Standards. Queensland Government departments are in the process of changing from cash based accounting to accrual based accounting. Queensland has no fundamental issue with the adoption of a Standard based on ED 62 and is planning to move in that direction with the production of a preliminary aggregate Statement of Financial Position for 1994-95.

A review of valuations of public assets is currently underway and the deprival valuation method is being applied to all significant assets, including heritage assets.

South Australia

The South Australian Department of Treasury and Finance is currently developing strategies to meet the requirements of ED 62 for whole of government reporting. A move from cash based to accrual based accounting is currently underway. The South Australian Government plans to have accrual accounting in place in the majority of budget sector departments by the end of the 1995-96 financial year and all Government controlled entities will be required to produce audited, accrual based financial statements for 1996-97. The methodology outlined in ED 62 is generally acceptable and while the process is in its very early stages it is planned to have the first whole of government report produced in 1996-97. Entities included in this report will be in line with the control test outlined in ED 62 with GBEs fully consolidated in the report. All physical non-current assets including heritage items will be valued using the deprival methodology except for items which have a life span of less than five years and cost less than $1 million where historical cost valuation will be optional.

While it is proposed to audit whole of government statements, the first report in 1996-97 may not be audited depending on the reliability of underlying information. No accrual based whole of government reports have been tabled to date.

Western Australia

For the period ended 30 June 1994 the West Australian Government published an unaudited whole of government consolidated financial statement In addition, portfolio departments are moving from audited cash based statements to full accrual accounting processes. The West Australian Government supports ED 62 proposals.

The 1994 Consolidated Financial Statement includes General Government,[5] Public Trading Enterprises,[6] Financial Enterprises[7] and Other Entities.[8] GBEs are included as Public Trading Enterprises and (as with all agencies) their presentation is fully consolidated. Land is included as valued by the Valuer General. Data on buildings and plant and equipment is also included. It is intended that in due course, the annual whole of government consolidated financial statements for Western Australia will be audited and the audited reports tabled.

Tasmania

Cash based reports are currently prepared in Tasmania. The Tasmanian Government is moving towards the adoption of commercial accounting principles for Government departments with accrual accounting being progressively implemented. However, the Tasmanian Government is only in the early stages in assessing the value of preparing whole of government reports and other priorities are taking precedence over these initiatives.

5 Those non-financial public sector agencies which are mainly engaged in the production of goods and services outside the normal mechanism or provide for the transfer of income for public policy purposes.

6 Those non-financial public sector agencies which are mainly engaged in the production of goods and services for sale in the market and whose objective is to recover at least a significant proportion of the operating costs through charges for their goods and services.

7 Includes agencies like state banks and insurance commissions.

8 Agencies which report under the Financial Administration and Audit Act (and which) are not covered under the Australian Bureau of Statistics' Government Finance Statistics.

The Tasmanian Government has a concern that ED 62 should not be put forward as a Standard which requires that the provisions are mandatory or override legislative requirements in individual jurisdictions. The Tasmanian Government's position is that whole of government reporting should not be mandatory, either explicitly or implicitly. The Tasmanian Department of Treasury and Finance puts forward the view that there would be 'considerable merit in ... delaying the promulgation of the Exposure Draft as a standard until 30 June 1996'.[9]

No whole of government reports have yet been produced.

Northern Territory

The Northern Territory Treasury supports the adoption of comprehensive whole of government reporting and already publishes several whole of government financial reports. Except for Government Business Divisions which have adopted accrual accounting the government sector uses uniform reporting standards on a Government Finance Statistics basis. The Northern Territory Treasury does not support the adoption of ED 62 in its present form because it believes the draft fails to recognise fundamental differences between the public and private sector such as governments' powers to tax, licence and regulate and the inapplicability to the government of the going concern concept. The Northern Territory Treasury has major reservations about the ability of the proposed standard 'to ensure relevant, reliable, comparable and understandable financial reporting' by governments.[10]

There are currently three whole of government reports prepared in the Northern Territory covering the administrative responsibilities, GFS and government purpose classification, each of which is predominantly cash based. In addition accrual type information is presented for all significant assets and liabilities.

9 The Department of Treasury and Finance, Tasmania, *Submission*, p. S241.

10 Northern Territory Treasury, *Submission*, p. S296.

The Northern Territory Treasury believes that there are a number of technical issues which must be resolved related to whole of government reports on an accrual basis before such reports can usefully be prepared.

Australian Capital Territory

The ACT Government is moving from cash based statements to full accrual based consolidated financial reports. The 1994-95 balance sheet will be in accrual format and the Auditor-General's comment will be sought. The 1995-96 statement will be in the form of a whole of government accrual based report and it is anticipated that this statement will be audited. The ACT Government proposes to have the 1996-97 consolidated financial reports prepared on a full accrual based system incorporating accrual budgeting and accrual accounting. The 1996-97 financial reports will also be fully audited.

The ACT Government is still making final judgements on whether or not GBEs will be fully consolidated in whole of government reports. It is proposed to value assets according to deprival methodology where, beyond a 5 year time horizon, there is no likelihood that the asset will be sold or otherwise utilised. If there is a likelihood that a sale may occur within 5 years valuation will be on current value. The ACT Government intends to table a consolidated financial report for 1996-97.

The Parliament of the Commonwealth of Australia

Joint Committee of Public Accounts

REPORT 342

THE ADMINISTRATION OF SPECIFIC PURPOSE PAYMENTS

A Focus on Outcomes

November 1995

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Canberra