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Financial Reporting by Governments – the Road to Damascus?

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1. INTRODUCTION

The Australian Government has been preparing financial reports since federation. From the time of federation, the Treasurer was required to keep a Cash Book and send the Cash Sheet together with vouchers on a daily basis to the Auditor-General for examination.[1] This was supplemented with the requirement to prepare and submit to the Auditor-General end of year cash financial statements.

While the process of the Auditor-General conducting a daily audit of cash sheets lasted for less than 20 years, the annual cash based reporting lasted for most of the twentieth century.

It was only in recent years, as a result of financial reform programs undertaken by the different government jurisdictions along with developments within the accounting profession, that the basis of this reporting has changed from cash to accrual.

During the 1990s, as the financial operations and expectations placed upon governments became more aligned with those of the private sector, the accounting profession turned its attention to financial reporting within and by governments. Accounting standards were released during the 1990s specifically dealing with reporting by governments. These included:

- AAS27 Financial Reporting by Local Governments;
- AAS29 Financial Reporting by Government Departments; and
- AAS 31 Financial Reporting by Governments;

each of which required the preparation of financial statements and specified requirements in relation to such reporting by these bodies. The expectation would be that government financial reports should be as good or better, for example in openness and accountability, than large corporations' financial reports.[2] However, there are concerns being expressed about the implementation of accrual accounting in the public sector which suggests that 'conversion' is still an issue, hence the sub-title to the address.

It is important to acknowledge the leading role taken by the accounting profession in Australia in setting these public sector specific accounting standards. They provided a common platform for the Federal and State governments to adopt as part of their framework to improve public sector performance.

Most governments within Australia now comply with AAS31 in preparing whole of government financial statements which consolidate the financial reports of all entities controlled by government. Financial statements should provide information about the government's financial position, operating results and cash flows. The overall financial position describes what a government owns (its assets) and what a government owes (its liabilities) at a point in time. Operating results report the extent to which a government's financial position has improved or deteriorated from one period to the next and includes information about revenues (or receipts) and expenses/expenditures (or disbursements). Financial statements also include information about future commitments and obligations.

These accounting statements are supplemented with the Government Finance Statistics (GFS) reports which are prepared on an annual basis by the Federal, as well as by each of the State, governments. The GFS statements report on two major fiscal measures as follows:

- the GFS net operating balance which is calculated as GFS revenue less GFS expenses; and

- the GFS net lending or fiscal balance which includes net capital expenditure but excludes depreciation.[3] As with the accounting statements, the GFS statements transitioned from a cash to an accrual basis during the 1990s in Australia.

This presentation focuses on the consolidated financial statements prepared by Governments in accordance with the accounting standards and in particular, *AAS31 Financial Reporting by Governments.* It begins with a short overview of whole of government financial reporting for selected countries and for Australian jurisdictions. This is followed by a discussion of a number of contemporary issues associated with such reporting, including some suggestions as to how the usefulness of these reports may be enhanced. I conclude by examining some non-traditional reporting models which could be used to complement these statements by increasing the information provided to users on government financial and some non-financial operations.

I do not doubt that Accountants will have to be more pro-active in achieving acceptance and use of financial reporting on an accrual basis by agency management as well as by the Government, Parliament and the general public.

2. FINANCIAL REPORTING ON A WHOLE OF GOVERNMENT BASIS

The move by many Governments from cash to accrual accounting, and even budgeting, over the last decade has focussed attention and interest on consolidated whole of government financial reporting. It has to be said that the initiatives did not generate a great deal of public interest. Nevertheless, there has been a burgeoning interest in the academic and accounting profession and, to a degree, among public service managers with the greater accent on market testing, outsourcing and greater private sector involvement in the public sector, both as a supplier to agencies and as a direct provider of public services.

International experience

It has been reported[4] that the first country to introduce consolidated financial statements on a full accrual basis did so in 1993; the first country to introduce budgeting on a full accrual basis did so in 1994. More than half of the OECD member countries have now adopted accrual-based approaches to some degree, and more are planning to do so.

New Zealand has been generally regarded as a leader in this respect. The *New Zealand Public Finance Act 1989* required financial reporting by the Crown, departments and Crown entities to be in accordance with generally accepted accounting practice, implicitly requiring the adoption of full accrual accounting. Full accrual accounting was implemented by all New Zealand government departments by 1991. This was followed by the preparation of consolidated accrual financial statements for the government sector in 1992. In 1993, the whole of government reporting entity was extended to include State-Owned Enterprises and Crown entities and, since that time, the New Zealand Government has prepared fully consolidated financial statements on an annual basis.

Unlike New Zealand, other countries such as the United States of America (USA), Canada and the United Kingdom (UK), are at various stages of transition to accrual reporting.

The US government has produced an audited Consolidated Financial Report for the federal government for the last four years under their 1996 Federal Financial Management Improvement Act. However, in all years, the auditor has been unable to form a view on the financial statements. The audit reports have included disclaimers of opinion due to serious deficiencies in the government's systems, record keeping, documentation, financial reporting and controls. At the time of signing the 2000 consolidated financial statements (March 2001), of the 24 major agencies of central government, only 18 had unqualified audit reports (up from 13 in the previous year).

The Canadian government is moving to full accrual reporting in 2000-01 as part of the Government's Financial Management Strategy. In the Canadian Auditor-General's Observations on the Financial Statements for the year ended 31 March 2000[5], he noted concern about the ability of departments to develop auditable estimates of significant assets and liabilities for the 2000-01 financial statements.

In the UK, the *Government Resources and Accounts Act 2000* replaced the *Exchequer and Audit Departments Act 1866.* Under the 1866 Act, government departments produced appropriation accounts which were prepared on a cash basis. The new Act requires government departments to produce resource accounts which are an accrual based commercial style of financial reporting. The first set of fully audited and published resource accounts were prepared in 1999-2000 in parallel with the departments' traditional cash based appropriation accounts.

The UK Government's Code of Fiscal Stability places a requirement on the Government to prepare consolidated financial statements for the public sector. The Government aims to produce the first audited Whole of Government Accounts in 2005-2006.

Australian experience

The Australian accounting profession first turned its attention to financial reporting within, and by, governments in the early 1990s. A project for the development of an accounting standard dealing with financial reporting by governments was identified as a high priority in 1992. In 1995, the then Public Sector Accounting Standards

Board issued an exposure draft on financial reporting by governments for comment. The proposed standard required the adoption of the full accrual basis of reporting and the preparation of consolidated financial statements by all Australian governments. Following an extensive period of consultation, the standard was released in 1996 with application from June 1999.

Since introduction of the standard, difficulties in implementing some aspects of the originally envisaged financial reporting framework have led to amendments to, and extensions of, some transitional provisions contained within the standard.

During the 1990s, the various state governments within Australia moved towards the adoption of this standard. Currently, the Commonwealth and the ACT, and all States except South Australia, publish audited consolidated financial reports. The Northern Territory produces cash based statements with notes providing some information on assets and liabilities. The South Australian Government produces accrual consolidated financial statements. However, these are not yet subject to full audit. Nevertheless, the South Australian Auditor-General does provide brief comment on those statements.

Importantly, most governments are enhancing financial reporting as part of wider financial management reform programs undertaken to improve overall financial management and accountability. The importance of this was acknowledged by the Commonwealth Joint Committee of Public Accounts back in 1995 when it stated in a report on financial reporting within the Commonwealth that:

> *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 for these reports will not be realised unless there is also a mechanism for feeding this information into financial planning and the Budget.*[6]

Currently:

- Australian governments are progressively implementing accrual budgeting. Most recently, the Tasmanian and West Australian governments implemented accrual budgeting in the preparation of their 2001-2002 budgets and the Northern Territory is undertaking a three year project to move to accrual based budgeting and financial reporting in 2002-2003.

- in Victoria, the Auditor-General reviews and provides negative assurance on the State's budgeted financial statements and the methodologies utilised in determining underlying budget assumptions. The first report on these matters was issued by the Auditor-General in May 2001; and

- in New South Wales, the Audit Office will be providing an opinion on the GFS, as well as on the consolidated financial statements of the government, from the 2000-2001 financial year.

3. THE USEFULNESS OF CONSOLIDATED FINANCIAL REPORTS

It is a moot point as to just how informative and useful accrual based government financial reports are to the various stakeholders. As you know, this has been a question posed and commented on by a range of academics, the media, investor groups and, indeed, by the general public in recent years. Indeed, a study prepared under the auspices of CPA Australia and published in 1999 argued that:

> *it was difficult to see any value adding from the current whole of government financial statements*[7].

However, this is not a shared view. Proponents of such reporting (of which the ANAO is one), argue that whole of government financial statements can provide a useful overview of a government's financial performance, its assets and liabilities and cash flows. The financial statements provide credible information upon which informed decisions can be made on the achievement of the government's overall objectives and in respect of choices that a government has made in the allocation of resources according to its various priorities and commitments. Over time, the statements will, for example, enable the reader to make an assessment of the degree to which the government is building up, or running down, its assets and/or liabilities.

Similar sentiments have recently been expressed by the Auditor-General for South Australia, who noted that:

> *It is over time, through the ability to make trend analysis of financial performance and financial position, that these statements become an important public sector financial management tool.*[8]

Unlike traditional cash reporting, the accrual measures provide comprehensive information on the revenue generated by a government and the full costs of its products and activities. Such information is an important element by which public sector managers are held accountable for the performance of their agencies in contributing to the achievement of government outputs and outcomes. Some argue that this justifies the move to accrual accounting and reporting more than does external reporting advantages. If this were so, it is probably more an argument for making improvements to external reporting and improving its usefulness to all stakeholders.

I noted in the introduction that the accrual financial statements provide an important supplement to the Government Finance Statistics (GFS) reports produced within each jurisdiction. The GFS reports include information on the two major fiscal measures indicated. In contrast, the whole of government financial statements provide only one bottom line, calculated on a basis consistent with any other financial reporting entity which is therefore arguably easier to interpret by the non-accountant user. This point was noted by Senator Gibson in recent proceedings of the Commonwealth Joint Committee of Public Accounts and Audit (JCPAA) which is undertaking a review of the Commonwealth's accrual budget documentation. In the course of Committee proceedings, Senator Gibson commented that :

> *We do have a system today where the government puts out a balance sheet of where it is at. We did not have that in the past. One of the advantages of putting out a balance sheet is that, instead of just half a dozen mandarins around the place understanding the government accounts, there have to be a million or two million people out in the community who understand a balance sheet …* [9]

Understanding Government accounts is not, of course, guaranteed from a knowledge of private sector accounts, such as balance sheets. As we all know, it is imperative that users are fully aware of the way in which such accounts are drawn up, including any apparent limitations, so that valid conclusions are drawn from them. To this end, it is important to acknowledge professional, academic and media concerns expressed about the general financial reporting framework and the ability to apply this framework to public sector reporting in a meaningful and useful manner, particularly as a basis for accountability of the government.

Arthur Levitt, Chairman of the United States Securities and Exchange Commission, has referred to financial reporting as a language[10]. He has argued that the critical financial decisions cannot be based on information that is inconsistent and incomparable. He illustrated this by reference to differing accounting practices as follows:

> *if one doubts the disparate effects that different accounting practices can have, consider again the case of Daimler-Benz. Under German accounting standards, Daimler reported a profit of 168 million Deutschmarks in 1993. Under US GAP Standards, the company reported a loss of almost a billion Deutschmarks for the exact same period. You can just imagine an investor's confusion and concern.* [11]

Closer to home, Telstra reported a profit of $4.061 billion under Australian standards and $ 3.576 billion under US standards for 2000-01, a not insignificant difference. Adding to this, is the difficulty seen by some in applying a framework designed for private sector financial reporting to the public sector. Emeritus Professor Allan Barton, among others, has argued that:

> *the accrual accounting system appropriate for the government is not the accrual accounting system used by business.*[12]

Challenges to both supporters and critics of a common reporting framework have been advanced by Susan Newberry. She argues that common definitions of the assets, liabilities and contributions by owners do not result in a common reporting framework if the interpretations given are different between the private and public sectors. She argues, for example, that common asset definitions and presentation of assets do not represent the same thing when the private sector references future net cash inflows and the public sector does not.[13]

Equally, she exhorts those who would assert the differences between the public and private sectors to pay closer attention to the actual practices proposed in the common framework and to the implications of those practices.

Given that most governments have now had reasonable experience in implementation of such reporting, it may be timely for a comprehensive review of the relevant accounting standards and the reporting framework they envisage.

This view is also reinforced by the harmonisation movement not only between national and international standards, but also between those of the public and private sectors. While there is apparent general support for the notion of harmonisation, there have been concerns expressed in both areas, including by the profession in Australia. The Australian Accounting Standards Board (AASB) issued an Exposure Draft (ED102) last July entitled 'International Convergence and Harmonisation Policy'. The Draft defined international convergence to mean 'working with other standard-setting bodies to develop new or revised standards that will contribute to the development of a single set of accounting standards for world wide use'.

The term, 'international harmonisation' is used to refer to a 'process which leads to these standards being made compatible with standards of international standard-setting bodies to the extent that this would result in high quality standards'. The Exposure Draft also makes specific reference to the International Federation of Accountants (IFAC) Public Sector Committee. I take this as a recognition of the broader harmonisation movement referred to earlier. While the increasing convergence of the public and private sectors in Australia, and in other western democracies, might make harmonisation somewhat easier, in my opinion there will still be a need to reflect variations in treatments, including disclosure, within any harmonised framework if it is to be credible. Failure to do so is likely to result in high level, quite generalised, standards to achieve agreement which would not satisfy anyone.

Public sector proponents have pointed to the need for standards to continue to recognise essential differences between the two sectors despite their growing convergence which, not surprisingly, is drawing greater attention to their essential differences. However, there is also a recognition that various changes in the financial management and regulatory environments, as well as in the standards arena, now require a re-examination of at least the three main public sector standards AAS 27, 29 and 31. Work is being undertaken in this respect at State and Commonwealth levels and within the CPA Public Sector Centre of Excellence. I should note that there are many public sector issues, such as taxation, provisions arising from social welfare arrangements and non-financial performance reporting, that are not covered by the International Accounting Standards.

The next section of this paper outlines some of the practical issues encountered in the application of the current accounting framework to whole of government financial reporting and is largely based on the Commonwealth's experiences.

4. SOME PRACTICAL ISSUES IN PREPARING GOVERNMENT FINANCIAL STATEMENTS

Before turning to discuss some of the accounting issues associated with the preparation of government financial statements, I thought it might be useful to set the scene by sharing with you some of our early lessons with preparation of these reports.

At the federal level, the groundwork for whole of government reporting was first laid in the late 1980s when government agencies were first required to prepare cash based financial statements and to incorporate these into annual reports which were to be tabled in Parliament. Until that time, only Commonwealth statutory authorities and companies included audited financial statements in their annual reports.

In the early 1990s, agencies adopted accrual reporting; albeit the statements were often prepared in a crude fashion by doing manual year end accrual adjustments to cash based financial records.

In 1996, the Commonwealth Department of Finance (now the Department of Finance and Administration), with the assistance of the ANAO, prepared a trial set of Whole of Government accrual financial statements for the year ended 30 June 1995. The statements presented a consolidation of the financial reports of all material Commonwealth controlled entities. The Minister for Finance released the results of that trial on 28 August 1996, some fourteen months after the end of the relevant financial year.

I am reliably informed that those fourteen months were spent in gainful employment by all involved in the process. There were a number of immediate issues which needed to be dealt with in the preparation of this inaugural set of financial statements. To ensure the quality and acceptability of these early decisions a steering committee, comprising representatives of the Department of Finance, the accounting profession and my office was established to oversight the process. It is relevant to note that this process occurred prior to the release of the accounting standard, so many of the decisions taken were without the benefit of the guidance subsequently provided by that framework.

At the working level, a joint team of Finance and my own officers was formed to prepare the trial statements. While it is unusual for auditors to be involved in preparation of financial statements, this was felt to be an important process within my office, both in terms of developing the expertise of my own staff together with influencing the direction taken in preparation and presentation of the financial statements. It is relevant of course, that these early statements were not subject to a formal audit process although an audit commentary was provided to the Department and the Finance Minister.

The first question faced by the steering committee was which of the then some 320 Commonwealth bodies were to be included within the consolidation process. There were two issues considered in that respect:

- what was the parent entity vis a vis the Commonwealth of Australia, the Parliament or the Executive Government and which Commonwealth bodies were controlled by the parent entity; and

- to what extent could immaterial entities be excluded from the consolidation process.

The question of control has proved a difficult one to resolve over the years with disagreements between the preparers and auditors on this issue occurring from time to time. This matter is discussed in more detail later in this paper.

The materiality question was relatively easy to deal with and was addressed, in the first instance, by aggregating the financial statements of all entities and then excluding from the consolidation process any entities which did not, in aggregate, make a material contribution to relevant classes within the financial statements. Currently, around half of the Commonwealth entities are excluded from the consolidation on the grounds of materiality. This restriction on the number of entities to consolidate has been an important contributor to improving the efficiency and timeliness of the whole process and is, no doubt, greatly appreciated by those smaller entities now excluded from the process.

The next major issue addressed was how to identify and resolve accounting policies which had been inconsistently adopted at an entity level or which were inappropriate at the government level. For example, the earliest discussions of the steering committee included consideration of matters such as whether the currency on issue from the Reserve Bank represented a liability of the Commonwealth (it does as the Reserve Bank receives funds from commercial banks in exchange for notes issued). They were also instrumental in identifying problems with the then treatment of grant obligations by Commonwealth entities which ultimately lead to revisions to the accounting standards.

The acceptability of accounting policies continues to remain one of the major issues surrounding preparation of Commonwealth consolidated financial statements. While differences of opinion are likely to arise from time to time between preparers and auditors of financial statements, the important lesson is that processes need to be established such that these issues can be identified and notified to the preparers of the consolidated financial statements as soon as they arise at an agency level.

The actual consolidation process itself has matured considerably in the Commonwealth since 1996. At that time, spreadsheets were developed and used to construct the consolidation. The absence of a standard chart of accounts across the Commonwealth meant that entities had difficulty aligning their own financial statements with the format of the consolidated financial statements and consequently, information not fitting within the consolidated format was often classified as “other”. This meant that, upon consolidation, the “other” categories often contained significant proportions of Commonwealth revenue, expenses, assets or liabilities.

In order to address this issue, the Commonwealth Finance Minister’s Orders were reissued and now contain a standard chart of accounts which must be used by all Commonwealth reporting entities (except those subject to the corporations law) in the preparation of their own financial statements. This chart of accounts has aligned the information presented within entity and consolidated financial statements and ensures that sufficient detail is provided on all material Commonwealth transactions and balances.

The other notable improvement in the process has been the development of the Commonwealth's accrual information management system by the Department of Finance and Administration (Finance) which now allows entities to enter accrual information on-line on a monthly basis.

It goes without saying that these changes have greatly enhanced quality and timeliness of preparation of the Commonwealth's consolidated financial statements. It is notable that the 30 June 2000 financial statements were published on 5 October 2000 : a commendable three months after financial year end. However, at the time of preparing this paper, the 2001-2002 statements had not been finalised.

Nevertheless, this is not to say that the process is not without its difficulties. As indicated earlier, one of the major continuing issues results from attempting to apply an accounting framework designed for private sector financial relationships to the public sector. One illustration is the so-called Capital Use Charge (CUC) which was introduced by Finance as part of the framework to enhance competitive neutrality in the pricing of agency outputs. In addition, it was to provide a return on the government's 'equity investment' in agencies. Finance explains that it was intended to place agencies on an equal footing with private sector firms which are expected to yield returns on their owners' investment in the form of dividends. Currently, the CUC is applied to net assets, considered to be 'equity' at a rate of 11 per cent. Its calculation takes account of the opening and closing balances for the financial year, including, for example, revaluations. Agencies with 'negative equity' or with operating losses are exempted from the charge.

Within generally accepted accounting practices, it is usual for dividends to represent a distribution of operating surpluses to the owner. This is reflected in the Corporations Law which states that dividends may only be paid out of profits. The imposition of the Commonwealth's capital usage charge on the net assets of an agency means that it is possible that the charge will be paid out of capital contributions or unrealised asset revaluation reserves. That is, it does not necessarily represent a return of surpluses to the owner. On the basis of this argument, the ANAO has raised with Finance the question as to whether the capital usage charge more accurately reflects a borrowing cost imposed on agencies by the government and is thus more appropriately disclosed as an expense.

Further, the current treatment, whereby funding for the charge is disclosed as revenue but its imposition is not shown as a corresponding expense, directly increases the operating result of an agency by the amount of the charge. This is a practical matter involving presentation and interpretation of budget-funded operating results. As an example, in 1999-2000, the Department of Defence reported an operating surplus of $5.3 billion compared to an equivalent $3.6 billion for one of Australia's largest corporate entities, Telstra. The significant difference is that $4.6 billion of the Defence surplus was subsequently remitted to government by way of the capital usage charge.

The remainder of this part of the paper outlines some of the issues encountered in application of the current accounting framework to whole of government reporting.

Accounting for taxation revenue

One of the issues which continues to pose challenges in the preparation and audit of Commonwealth financial statements is in respect of how to recognise taxation revenue.

The accounting framework requires that an asset be recognised when there is an economic benefit, which is controlled by the Commonwealth and which can be reliably measured[14]. In line with this requirement, prior to 1998-99, taxation revenue was recognised at the point when the underlying transactions, which gave rise to taxation liabilities, occurred. Generally, this was at the time assessable income was earned by the taxpayer. This method is referred to colloquially as the Economic Transaction method, or ETM, and is the method used by the Australian Taxation Office (ATO) in preparation of its financial statements.

Initially, the Commonwealth Government also adopted the ETM in preparation of its consolidated financial statements. However, in 1998-99, in an attempt to obtain greater precision over its accounting estimates, the Commonwealth Government changed its accounting policy in relation to taxation revenue, recognising the revenue when payments are due and payable according to taxation law or upon assessment (the Taxation Liability method, or TLM). The effect of this change in policy is a deferral of the time at which taxation revenue is recognised within the financial statements.

Specifically, in the 30 June 2001 financial statements, the effect of this policy was to understate the Commonwealth Government's result for the year by $3.9 billion and net assets by $13.9 billion.

The main problem with TLM, however, is that taxation revenue does not reflect the underlying economic activity giving rise to the revenue. In particular, the amount of the revenue will be affected by changes in the taxation law as to when amounts are due and payable or by changes in the timing of ATO assessment. The Budget Papers and Final Budget Outcome[15] (which is an unaudited statement in the Commonwealth) reflect the fact that the actual budget surplus has been assisted by the bringing forward of company and superannuation tax collections.

We can expect that the same effects will be seen in the accrual based result for the year, so that the surplus to be reported under the TLM may well, for once, be greater than if the ETM had been used – a turnaround based on changes in administration of tax law rather than in underlying economic activity.

Following extensive consideration of this issue, the ANAO concluded that the treatment adopted by the Commonwealth in 1999-2000 was not in accordance with the requirements of Australian accounting standards and has, accordingly, qualified the Commonwealth Government's consolidated financial statements on this issue. Needless to say, there is some disputation about this view which centres around accuracy of the estimates of taxation revenue under the two methodologies (including budgetary considerations) rather than about adherence to accrual principles.

This issue illustrates one of the difficulties confronted in attempting to apply traditional accounting concepts to a regime which is legislatively, rather than business, based. In the standard business model, there would be no question, in the accrual world, that revenue should be recognised at the time goods and services are provided. What is the analogous point to recognise taxation revenue earned by governments? The answer lies somewhere along the spectrum between "the right to tax" and the actual receipt of taxation payments. In my view, the obligation exists prior to assessment.

It is the underlying transactions, not the assessment, which give the Government control of the right to receive taxation revenues. The financial statements of the ATO recognise taxation revenue when the Government gains control of the future economic benefits that flow from taxes and when those future economic benefits can be measured reliably. We undertook statistical analysis with the ATO to ensure that such measurements fell well within audit materiality limits.

A similar issue in relation to taxation accounting is the treatment of the goods and services tax or GST. The GST is imposed by Commonwealth legislation. Agreements entered into with the various State governments provide for the Commonwealth to collect this tax and forward it to the States. The Commonwealth will recover the costs it incurs.

Both the Commonwealth's 2000-01 Budget papers[16] (May 2000) and the Overview in the Final Budget Outcome[17] (September 2001) were prepared on the basis that the Commonwealth Government was simply acting as the agent of the States and Territories in levying and collecting the GST, and therefore neither document recognised the GST as Commonwealth revenue, or the associated payments to the States and Territories as a Commonwealth expense[18]. Conversely, State governments have preferred to classify GST revenue as general purpose funding from the Commonwealth within their budget papers.

In the ANAO's opinion, the better view is that the GST is controlled by the Commonwealth and, as such, should be recognised in the consolidated financial statements. This view is supported by the Australian Bureau of Statistics[19] which has advised that, for GFS purposes, the GST should be accounted for as a Commonwealth tax. Similarly, the Department of Treasury and the ATO have each recognised the GST as a Commonwealth tax within their respective financial statements:

- the ATO which reports the GST collected; and

- the Department of Treasury reporting the payment of GST equivalent amounts to State governments.

At the time of preparing this paper, final Commonwealth Consolidated Statements had not yet been presented for audit. Given its materiality, a failure to recognise the GST could be expected to attract a qualified audit report.

Defining the reporting entity

As indicated earlier, an area of some difficulty in preparation of government financial statements is applying the tests of "control" laid down in accounting standards to identify which entities to consolidate and which to omit from the financial statements.

AAS31 *Financial Reporting by Governments* defines control as the capacity of an entity to dominate decision making in relation to the operating and financial policies of a second entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity. It states that the following two factors are indicative of control of an entity by a government:

- the entity is accountable to Parliament, or to the Executive, or to a particular Minister; and

- the Government has the residual financial interest in the net assets of the other entity.

Interpretation of these provisions has proved a challenge both for the auditors and preparers of consolidated financial statements.

The financial statements of the New South Wales Government have been qualified on the grounds that certain trusts, relating to the Government's Home Fund program, have been excluded from the consolidation. The New South Wales Auditor-General has concluded that the Home Purchase Assistance Authority controls the Trust as it has the capacity to control the Trust's decision-making in relation to financial and operational policies and, accordingly, the Trust should have been consolidated. Such consolidation would have required assets and liabilities of some $321 million at 30 June 2000 to be recognised in the New South Wales consolidated financial statements[20].

A similar issue applies in relation to the consolidation of universities within government consolidated financial statements. Presently, neither the Commonwealth nor State governments consolidate the universities. Some argue that the Commonwealth Government should consolidate all universities in its accounts on the grounds that it provides funding for universities. However, the logical extension of this argument would be for the Commonwealth to consolidate charities, schools, hospitals and perhaps even State governments to which it also provides funding. Importantly, the accounting standard quite clearly states that the provision of funding is, by itself, not an indicator of control.[21]

It seems reasonable to examine the legislation supporting the establishment of the various Australian universities to determine which, if any, have been established under the control of governments. An ANAO analysis has indicated that only the Australian National University (ANU) is captured within the definition of control by the Commonwealth contained within AAS31. Even this is by way of the test of accountability to the Minister and Parliament by virtue of application of the *Commonwealth Authorities and Companies Act 1997* to the University as opposed to the more traditional control tests in relation to composition of boards etc.

The Commonwealth's view is that it does not "control" the ANU and, accordingly, has elected not to consolidate that university within its consolidated financial statements. Given the immateriality of the University within the context of the overall financial statements, this decision has not attracted a qualification in the ANAO's audit report. Simply, the law of large numbers applies.

However, there are organisations which have a material impact upon the Commonwealth Government's consolidated financial statements. While controlled in terms of the accounting standards, they could reasonably be argued to belong, in a real sense, to specific taxpayer groups. The types of organisations concerned could include various industry marketing and research bodies, which are funded by levies imposed on industry and which undertake marketing or research activities at the behest of industry. Similarly, while Medibank Private is owned (and therefore consolidated) by the Commonwealth, it could perhaps be argued that the net assets of this organisation, which were funded by members' contributions, actually belong to the fund members under some kind of mutual fund arrangement.

The accounting standards have not, and realistically could not, have been designed to cater for these specific types of arrangements. However, the inclusion or exclusion of such organisations can have a considerable impact upon the consolidated financial statements and, as indicated earlier, are often an area of contention between the auditor and the Government. This is another dimension of the problem of understanding and interpretation of financial results referred to earlier in the quoted comments by the Chairman of the US Securities and Exchange Commission.

Non-reciprocal transfers

A further area where accounting standards have encountered difficulties in providing an appropriate accounting outcome is the treatment of non-reciprocal transfers. This has created issues for government accounting with consequent impact on its financial results.

The accounting framework reflects a commercial model whereby the vast majority of transfers are reciprocal. That is, when an entity transfers its assets, it will generally receive assets of approximately equal value in return. Stated simplistically, payments will generally result in the return of goods and services of equal value to the entity. Therefore, if an entity incurs a liability for future expenditure, it will most often be entitled to record the right to receive the ordered goods and services as an asset. To the extent that the mutual obligations are equally unperformed, no asset or liability is required to be recognised on the balance sheet.

Non-reciprocal transfers, which are a feature of government financial activity, do not fit neatly into the accounting framework. Under this scenario, the transfer of resources does not result in a return of assets to a government. If a government incurs a liability in an area such as social welfare, for example, there is no asset which can be used to offset that liability. This has meant, in practice, that governments have been required to fully expense liabilities at the time they are incurred.

As an example, the Commonwealth enters into agreements with the States each five years for the amounts of medicare funding to be provided to the States. Such funding is a non-reciprocal transfer as the Commonwealth receives no benefit directly in return for the payments. At the time the Commonwealth Government prepared its first trial set of whole of government financial statements, the existing policy was to recognise the full medicare liability and expense in the year that the agreements were entered into with the State governments. The basis of this treatment was that there was a "past event" (the agreement) which created an obligation on the Commonwealth Government to transfer funds.

Given there was no associated asset returning to the Commonwealth, the liability for the full term of the Agreement, together with the associated expense, were required to be recognised in the year incurred. This meant that, under the accounting standard, every fifth year the Commonwealth incurred medicare funding costs, but for the remaining four years, no medicare funding expenses were recognised. Quite clearly, this was not a sensible result as such expenses are incurred continually, not at the time funding agreements are entered into.

In response to this issue, amendments were made to the commentary in relevant accounting standards, stating that:

> *Transactions or other events which do not give rise to a present obligation to sacrifice economic benefits to another entity in the future do not meet the definition of liabilities. The intention of a government to make payments to other parties, whether advised in the form of a budget policy, election promise or statement of intent, does not of itself create a present obligation which is binding on the government. …A government does not have a present obligation to sacrifice future economic benefits under multi-year public policy agreements until the grantee meets conditions such as grant eligibility criteria or has provided the services or facilities required by the grant agreement. In such cases, only amounts outstanding in relation to current or previous periods satisfy the definition of liabilities.*[22]

This amendment, while well-intentioned, has proved difficult to implement consistently as is evidenced by the fact that a consensus view issued by the Urgent Issues Group (UIG) on the treatment of operating grants paid to universities was recently overruled by the Australian Accounting Standards Board. The board noted that it was not satisfied the payments made to Universities are reciprocal transfers. It decided that:

> *The general issue of accounting for grants is of such a magnitude that it would include the topic on its agenda rather than remit the proposed Abstract to the UIG for further consideration.*[23]

There are clearly different views being expressed on the notion of non-reciprocal transfers which need to be reconciled as a test of the standards process and its usefulness.

The lack of clarity in the standards on this issue has lead to some inconsistency between governments on application of this policy. Once such area is in relation to the treatment of a commitment from the Commonwealth to fund, on an emerging cost basis, unfunded liabilities of certain university superannuation schemes. While the Commonwealth reports this as a commitment and not a liability (on the grounds that any payment is discretionary on the Commonwealth until the appropriate Minister makes an annual determination) some States have instructed universities to record a receivable against the Commonwealth which has resulted, in at least one case, in the university concerned receiving qualified audit reports.

Again, this is an area where the accounting framework has struggled to provide an appropriate accounting outcome. The question seems to be what is the relevant past event that gives rise to the liability. The answer is not immediately obvious. The more relevant issue for this paper is the lack of consistency, and resulting problems of interpretation, of the Commonwealth's financial statements, if not for the States' ones as well.

My Office would argue that the area of non-reciprocal transfers is one of the two areas in greatest need of review if existing accounting standards are to adequately facilitate the needs of public sector reporting.

Asset valuation

The second area of greatest need of review is the area of asset valuation. The ANAO has devoted considerable time and resources on this important aspect of financial statement reporting in recent years, including production of a Handbook and Better Practice Guide[24] and numerous workshops.

When Commonwealth agencies were first required to prepare accrual based financial statements, the identification and valuation of many assets proved difficult given the paucity of historical records. As well, it was argued that, in an environment of rapidly changing technology and pricing, historical cost was not an appropriate measure of remaining service potential or even of periodic consumption, particularly from the often long useful lives of public sector assets. There is also a focus on accountability for performance in terms of both efficiency and cost effectiveness and on resource allocation in the budget context. Consequently, the Commonwealth, as well as most other State jurisdictions, resorted to current cost or similar valuation methods.

The Commonwealth elected to adopt the deprival value model as this model allowed the current cost of operations to be reflected within financial statements. Under this model, assets are valued on alternative bases depending upon the anticipated action of the agency in the event that it were deprived of the asset. Those assets held for sale or which would not be replaced in the event that the agency were deprived of them, are valued at a market value. Those assets which would be replaced if lost, are valued at depreciated replacement cost. With the introduction of *AAS38 Revaluation of Non-Current Assets*, the Commonwealth will be moving to fair value accounting for year end 2003 with the assets valued having regard for the highest and best use of the asset for which market participants would be prepared to pay.

The move towards the introduction of fair value accounting is not uncontroversial. Miller and Loftus reported in July 2000 that:

> *In Accounting Theory Monograph 10 (ATM 10), published by the Australian Accounting Research Foundation (1998), it is argued that "value to the entity is the most relevant measure of an entity's assets and liabilities". That favourable assessment of the value-to-the-entity concept is shared by the Accounting Standards Board in the UK and the International Accounting Standards Committee seems to be favourably disposed towards the concept because it has drawn on it in preparing its standard on asset impairment. Nonetheless, the standard-setting boards of the US and Australia, in recent standards, have avoided this entity-specific notion in favour of the concept of "fair value".*[25]

Horton and Macve argued in 2000 that the current approach to accounting for financial instruments based on the (then) IASC's interpretation of fair value was conceptually flawed and therefore unworkable in practice. They suggested that standard–setters needed to reintegrate their approach to financial instruments with the 'deprival value' theory set out in ATM 10 if they wished to produce proposals that would gain international support.[26]

The South Australian Auditor-General has also sounded a word of caution. Noting the origins of the deprival methodology in Government as an approach designed at considerable cost "specifically for government assets which in many cases are unique and have in most cases no equivalent in the private sector", he exhorts the SA Government to be "totally satisfied" before adopting fair value that this basis adequately accounts and reports on the value of all government assets.[27]

It is also interesting to note that the AASB is reconsidering its fair value approach to impairment of assets proposed in ED 99 "Impairment of Assets". It has agreed that it is preferable to adopt the approach in IAS 36 "Impairment of Assets", which applies the higher of net selling price or value in use in determining the recoverable amount of an asset. The Board has decided to develop a further ED based on the requirements of IAS 36.[28]

Notwithstanding the introduction of fair value accounting, the debate continues over the appropriateness of attempting to value and incorporate in balance sheets, assets such as those of a heritage or environmental nature. The recognition and measurement of heritage assets is a contentious issue. In recent times, some legislatures have adopted a policy that, as an asset of this nature has no alternative use, there should be no valuation other than a nominal $1 in order to recognise it in their financial statements.

What is the appropriate value for an item of historical interest such as Captain Cook's journal which is held by the National Library? Is it the replacement cost of the parchment and quill? Is it the market value of this rare historical artefact? How do you determine a market value if the document is not traded and is it misleading to adopt a market value when there is no intention of ever disposing of this asset? Following the deprival methodology, the journal has been valued by the Australian Valuation Office at market value which the ANAO has accepted for audit purposes.

Should we, and if so how should we, go about valuing our national and state parks? Is it appropriate to take account of the retail value of the timber and the market value of the many quarter acre blocks contained within such parks? Or is the real value of these parks captured by some measure of their environmental and heritage value? The purpose of such questions is to seek answers at least for the purposes of better resource management, assessment of performance and accountability for that performance. In answer to the question posed, the more significant national parks administered by the Commonwealth are leased from traditional owners and accounted for accordingly. Those parks belonging to the Commonwealth are currently valued at current market buying price.

What about land under roads? The profession has struggled to find a solution to this issue with accounting standards encouraging, but not requiring, such land to be valued by governments. Of those State Governments which prepare financial statements in accordance with AAS31, the majority have elected not to attempt to value land under roads (Queensland, New South Wales, Victoria and South Australia) or to assign such land a nominal value (Australian Capital Territory). Only Tasmania and West Australia currently assign values to such land.

So too, the valuation of intangible assets remains a challenge for the profession. A recent paper[29], presented by Wayne Timson of the Australian Valuation Office to the CPA Congress 2000 comments that intangible assets, particularly those which are internally generated, can have a significant impact upon an entity's ability to produce income and its shareholder value. He notes that current accounting standards do not allow the recognition of all such assets and argues that, as a consequence:

> *decisions based solely on the content of modern financial reports have the potential to be incorrectly based, to the possible detriment of business.*[30]

An important example of interest to a number of agencies has been the capitalisation of internally developed software. In many cases, such software is expensed immediately or over a fairly short time period. One deficiency has been the lack of reliable records of the development cost. Wayne referred to a valuation model he had developed to overcome this deficiency and which had been accepted by the ANAO as satisfying the deprival value concept.[31]

Most recently we have witnessed considerable discussion about the treatment of goodwill, particularly about the notion of systematic write-off. I was interested to see that the Group of 100 (comprising Australia's chief financial officers) has agreed to field tests of the US standard SFAS 142 to assess the practicalities of accounting for intangible assets.[32] David Boymal, National Director of Accounting and Audit for Ernst and Young thinks the US approach is 'theoretically right' even with the greater volatility implicit in the new impairment model. It is likely that the US standard does offer some hope for the improved reporting of the value of those assets in David's opinion.[33]

In section 6 of this paper, I will discuss emerging developments in the reporting of intellectual capital.

Interpretation of results

To properly interpret any financial statements, a user requires a detailed understanding and appreciation of the various accounting policies adopted and how these policies have shaped the financial results.

The accounting policies used in preparation of public sector financial statements reflect public sector funding and financial arrangements. They are thus unlike the accounting policies adopted within the private sector and are, in many ways, more complex. This can make interpretation of these statements difficult, and, if users do not understand the differences in the models and policies adopted, can lead to erroneous conclusions in relation to the financial results.

One has to wonder just how many citizens really appreciate the question of whether it is really appropriate to place market values on assets which will, most likely, never be disposed of and are not used to generate any financial return? What does the aggregation of all of these values mean in practice and what concern or assurance does it provide to citizens?

Should we omit from the calculations legislatively based obligations on the grounds that services have not been provided; notwithstanding that, in all probability, settlement of the obligations will be required?

In the next section of this paper, I will discuss the means by which users can be assisted in their interpretation of financial statements and the statements can thus become more relevant and useful.

5. ENHANCING THE USEFULNESS OF GOVERNMENT FINANCIAL REPORTS

It would be reasonable to assume that the majority of citizens would not have the necessary understanding of government accounting policies and practices to properly interpret what these financial statements are conveying. Arguably therefore, this could result in a breakdown in the accountability chain. One way of addressing this and ensuring that the financial statements serve their purpose of providing users with an overview of the government's financial performance and position, is to provide additional analysis of the information contained within the financial statements. This would be in the nature of a Management Discussion and Analysis (MD&A) document which would have some parallels with the private sector practice.

Most State governments and/or their audit offices conduct such analysis and publish it with the financial statements or the audit report thereon. To illustrate how such analyses can improve the overall value and usefulness of the government financial statements, I refer to some useful work performed by my colleagues in the Victorian Auditor-General's Office.

The *Report of the Auditor-General on the Finances of the State of Victoria, 1999-2000*[34] contains a three part analysis of the State's financial condition. The first part of the analysis, predictably, contains a discussion of the annual operating result and financial position together with the key factors which have contributed to these results. For example, the report notes that:

> *The key factors contributing to the lower operating result achieved in the 1999-2000 financial year were increased expenditure associated with employee entitlements ($128 million), superannuation ($899 million), supplies and services ($1.5 billion), and grants and transfer payments ($160 million). These increased expenses were mainly due to wages growth, the provision of additional health and education services, and the revaluation of the outstanding claims liabilities of the State's workers' compensation scheme (WorkCover) and unfunded superannuation liabilities …*[35]

A similar analysis is conducted on movements in the Statement of Financial Position.

In Victoria, the government has established in legislation a number of key principles of sound financial management which underpin the State's financial and budget strategies. In its budget papers, the Government specifies a series of long and short-term financial objectives which are consistent with these principles. The objectives include matters such as "maintain a substantial budget sector operating surplus" (long term) and "achieve an operating surplus of at least $100 million in each year" (short term). In the second part of its analysis, the auditor's report considers the Government's performance against these stated financial objectives concluding that:

> *These developments and achievements indicate that the Government has been successful in meeting its short-term financial objectives, nevertheless, there remains the need for strong leadership to ensure that the full benefits of progress to date are maintained.*[36]

The final section of the report includes an analysis of the State's financial condition. The report assesses three indicators of the State's financial health and strength concentrating changes in these indicators over a period of four years. The indicators examined are as follows:

- *sustainability* or the extent to which the Government can maintain existing programs and operations, and meet existing creditor requirements without increasing the debt burden on taxpayers. In considering sustainability, the auditor considers factors such as the level of the operating surplus or deficit, the level of State borrowings and the percentage of such borrowings as a proportion of the State's gross state or domestic product (GSP), the level of liabilities both as a proportion of the State's GSP and in comparison to total assets and the relationship between finance charges and total expenses;

- *flexibility* being the degree to which the Government can increase its financial resources to respond to rising commitments, by either expanding its revenue or increasing its debt burden. In considering flexibility, the auditor considers factors such as the proportion of the State's GSP sourced from own revenue, the proportion of total revenue consumed by finance charges and total expenditure compared to State GSP; and

- *vulnerability* – or changes in the extent to which the Government is dependent on, and therefore vulnerable to, sources of funding outside its direct control or influence. Factors influencing vulnerability include the proportion of total revenue contributed by the Commonwealth, the proportion of total revenue consumed by finance charges, borrowings as a proportion of State GSP and foreign currency borrowings as a proportion of total borrowings.[37]

Those of you from Victoria will be pleased to hear that the Auditor-General concluded that the State's financial position as at 30 June 2000 had made progress during the financial year with improvements in:

- the Government's capacity to maintain existing programs and operations;
- the Government's flexibility in responding to future opportunities requiring financial resources; and
- the State's vulnerability to funding resources not directly within its control.

Without getting involved in the debate at the time about whether the Auditor-General was stepping over the line in terms of his mandate, the Victorian approach illustrates the importance of interpretive information to assist readers to understand the financial performance and position.

However, the larger question is whether these financial statements, even when properly interpreted, are a sufficient accountability mechanism for governments. It is a reasonable proposition that the role of governments is, amongst other things, to provide services to the community. The primary accountability in this context should therefore be in relation to the quality and quantity of services delivered and the impact of the delivery of such services and government activities on the community. The financial consequences, while important, are secondary to the outcomes to be achieved.

Given this, I would argue that, even with detailed analysis and commentary, financial reporting by governments does not entirely meet the accountability expectations of constituents as it does not provide information about the services delivered by a government to the community nor does it address the broader impacts of government actions on the community. There is a real question as to whether it should.

For example, financial reporting does not measure the quality of services or assets provided to a community by the government. Issues such as the availability and sustainability of infrastructure, the quality of education provided to our children, or the availability of health facilities, have a direct impact upon our well-being and are not reflected in traditional financial reporting.

Similarly, while a government's actions and decisions can have a significant impact upon the environment, both in terms of the overall policy agenda as well as internal management practices, there is very little reflection of such impact in financial reports. In most cases, financial reporting is limited to quantifiable liabilities which may exist as a result of property restoration, related obligations or the like. Also lacking from the financial reports is any measure of intellectual and human capital which can be significantly impacted by government policies and actions.

The next section of this paper outlines some contemporary developments which have, at least, the potential to better meet accountability expectations and perhaps present a more holistic picture by expanding upon the reporting which occurs within "traditionally-based" financial statements.

6. REPORTING ON THE FINANCIAL PERFORMANCE OF GOVERNMENTS

Accent on performance reporting as a major element of accountability

Performance measurement within the Australian Public Service is increasingly focusing on more than just a financial bottom line. Assessments typically cover a range of measures, both quantitative and qualitative. For example, an agency or entity has to be accountable for the implementation of the Government's requirements with respect to public sector reforms and for meeting relevant legislative, community service and international obligations; for equity in service delivery; and for high standards of ethical behaviour. This point has been recently emphasised by Max Moore-Wilton, Secretary, Department of the Prime Minister and Cabinet, as follows:

> *Ministers and Departments do have an obligation not just to achieve the bottom line that is often the key outcome sought by private companies. We owe it to the community to establish public trust that we work with integrity and put public interest ahead of personal gain. Ensuring the transparency of our processes can focus our minds on the need for each individual decision we take to be justifiable in terms of strict propriety.*[38]

In order to accurately assess performance, it is necessary to identify both the financial and non-financial drivers of agency business. Within the Commonwealth sector, such assessment is underpinned by the introduction of the outcomes and outputs framework associated with the implementation of accrual budgeting. The outcomes and outputs framework focuses on what agencies are producing (outputs), the resources they are administering on behalf of governments (administered items) the purposes of outputs and administered items (outcomes) and the cost, in accrual terms, of these activities[39]. This model is intended to assist management decision making and performance by focussing attention on the Government's goals and objectives.

The identification of appropriate performance indicators, together with the reporting of actual results against these performance indicators, becomes a key plank within this new accountability framework. This applies particularly with the greater management flexibility provided by the Public Sector Reforms, including principles-based legislation, which is more advisory than directive.

In assessing overall organisational performance, the use of techniques such as the balanced scorecard approach, promoted in the then Management Advisory Board's

(MAB) publication *"Beyond Bean Counting"*, are becoming more prevalent. In MAB's words:

> *The scorecard…complements the financial measures with operational measures on customer satisfaction, internal processes, and the organisation's innovation and improvement activities - these operational measures are drivers of future financial performance.*[40]

The scorecard approach underlines the importance of the various linkages and their understanding and management such as between strategy and operations, budgets and performance. It also requires that attention be given to measuring performance, where practicable, and to articulating a credible basis for assessing qualitative, or so-called "soft", indicators of success. A parallel is the distinction between "price" and the "value for money" concept, with the latter often embracing many non-price factors.

Triple bottom line reporting

Within the foreseeable future we can expect to see an emergence and consolidation of new modalities of accountability. One example is the so-called Triple Bottom Line Reporting (TBL) which has been defined as reporting that provides information about economic, environmental and social performance of an entity[41].

TBL aims to provide information to users indicating that the entity is financially secure, minimising or eliminating negative environmental impacts and acting in conformity with societal expectations[42]. A recent article suggested that the current socio-legal construction of accountability in the business world – and I would include government operations in this category – is on the threshold of a major paradigm shift[43]. Public and other stakeholders' expectations in an increasingly globalised business and communications environment will, according to the article's author and other proponents of the TBL, provide the drivers for a shift away from the traditional *input-output* based model of accountability towards a focus on *economic prosperity, environmental quality and social justice*[44].

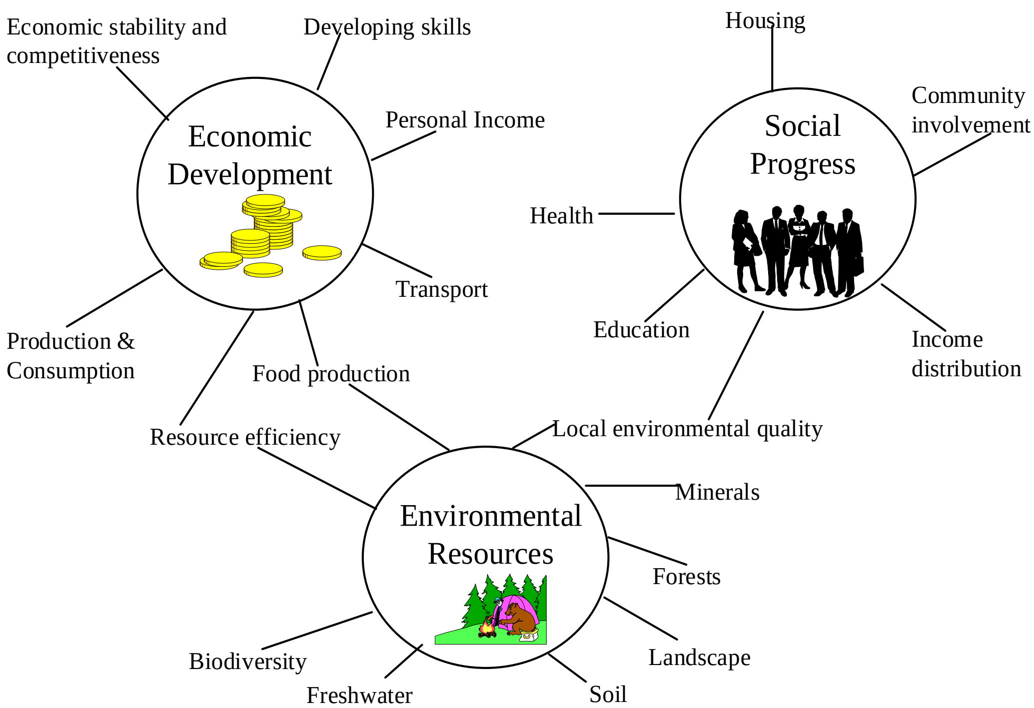
TBL, or sustainability reporting, requires less reliance on output indicators and an increased focus on calculating the externalities associated with a business or activity. In particular, TBL seeks to overcome the limitations of traditional financial accounting, such as:

- a restricted focus on the interests of stakeholders with financial interest in the entity;
- adoption of the "entity" assumption according to which transactions or events which do not directly impact the entity are ignored for accounting purposes;
- defining expenses so as to exclude the recognition of impacts on resources not controlled by the entity (such as the environment); and

- recording only those items which can be measured with reasonable accuracy (whereas, many environmental or social externalities may not be capable of accurate valuation).[45]

It goes beyond the current orthodox focus on financial performance (in the narrow sense of profit and loss), the utilisation of inputs and the disposition of outputs, and probity (expressed as conformance with applicable law and the minimisation of liability) to also take into account the environmental and social consequences of business activity. The concept of sustainable development incorporates three dimensions: monitoring high and stable levels of economic growth; social progress which recognises the needs of all citizens; and protection of the environment and prudent use of resources. The following figure illustrates the wide range of issues that can be involved. The figure does not reflect all the linkages that might be possible nor all the issues that could be covered.

Figure : Some Issues Relevant to Sustainable Development



Source: INTOSAI Working Group on Environmental Auditing 2001. *Sustainable Development : The Role of Supreme Audit Institutions*. Presented at XVII INCOSAI Seoul. October. P.6

While the areas of economic or shareholder value are well developed and understood, indicators of environmental or social value-added remain to be comprehensively developed. Indicators of corporate environmental performance might include:

- *materials use*: quantities and types of material used. This indicator tracks resource inputs, distinguishing their composition and source;

- *energy consumption*: quantities and types of energy use or generation. This indicator, the energy analogue to materials use, also differentiates between types;

- *non-product output*: quantities and type of waste created before recycling, treatment or disposal. This indicator distinguishes production efficiency from end-of-pipe pollution control; and

- *pollutant releases*: quantities and type of pollutants released to air, water and land. This indicator includes toxic chemicals, as well as greenhouse gases, solid wastes, and other pollutants.[46]

Basic elements of corporate social performance might include:

- *employment practices*: The provision of a safe working environment; financial and job security; freedom from discrimination on race, gender, colour or creed; and opportunity for professional development;

- *community relations*: The contribution of a company to community development, including: job creation; taxes paid/tax breaks received; philanthropy; and employee volunteerism;

- *ethical sourcing*: Engagement in fair trading practices with suppliers, distributors and partners; ensuring that suppliers do not use child or forced labour; provision of safe working conditions and fair wages; and

- *social impact of product*: The contribution of products and services to: social welfare; equity; and the meeting of basic human needs, such as food, shelter, water and health care.[47]

TBL reporting could lead to changes to the manner in which public and private sector organisations report performance and discharge their accountability to their stakeholders. The concept of sustainability requires new definitions of performance and the re-articulation of organisational goals. In the private sector, this would involve some balancing of environmental and social considerations against profitability. A recent study indicates that there is general corporate resistance in Australia to the provision of environmental information to external stakeholders in satisfying accountability obligations, unless the information provided reflects positively on the organisation.[48] The authors commented further that:

> *The accounting profession and the regulatory authorities' prescriptions are of a self-regulatory nature, and seem part of the global push for business self-regulation.*[49]

The public sector may be inherently better positioned for the application of TBL given the focus on *outcomes* as a primary measure of performance in the absence of any profit concept to assess results. Even publicly owned commercial operations may be amenable to TBL given the prevalence of community service obligations in their charters. Much of the Australian public sector (Federal, State and local) requires agencies and their suppliers to demonstrate conformity to industrial, affirmative action and environmental legislation and associated practices in their annual reports.

Key barriers to the adoption of TBL reporting include the lack of standard methodologies; the lack of appropriate skills, knowledge and/or experience and the difficulties of identifying social and environmental costs and the valuation of liabilities. TBL can only proceed from a strong interdisciplinary base. In addition to the traditional accounting, statistical, and management knowledge and, more recently, an ethical skills base, TBL requires the skills of environmental and social scientists, engineers and technologists.

Some organisations are moving to develop comprehensive guidance for reporting environmental and social information. The Australian Auditing and Assurance Standards Board has established an Environmental Reporting working group to progress an environmental reporting project in Australia. Guidance for the conduct of audits of activities with an environmental perspective was presented at a recent international conference of National Audit Offices in Seoul.[50] A social accounting standard was released in 1998 by the Council for Economic Priorities entitled SA8000. It focuses on issues associated with human rights, health and safety and equal opportunities.

In November 1999, the Institute of Social and Ethical Accountability launched AA1000, which is concerned with the processes of setting up social and ethical accounting and auditing systems.[51] The Global Reporting Initiative (GRI) has been convened by the Coalition for Environmentally Responsible Economies in partnership with the United Nations Environment program. GRI has the mission to develop and disseminate globally applicable sustainability reporting guidelines for voluntary use for reporting economic, environmental and social dimensions of their activities.

This is clearly a *"greenfield"* area for research and development as far as the accounting profession is concerned. Moreover, because of the trans-border and global issues inherent in TBL, the development of appropriate methodologies and indicators would benefit enormously from international input. As the outcome of the December 1999 World Trade Organisation (WTO) meeting in Seattle demonstrated, there is a significant north-south divergence in priorities and perspectives between the industrialised and post-industrial countries and those that are less developed and industrialising. The potential exists for the accounting profession to contribute to constructive dialogue and rapprochement on such issues and approaches. However, any progress may well largely depend on a more knowledgeable and demanding community expressing its preferences in the Ballot Box and/or share market.

Valuing intellectual capital

Intellectual capital (IC) comprises factors such as intellectual property rights, research and development, customer networks, business processes, human capital and organisational processes and structures. That is, IC encapsulates both structural and human capital. Organisations now acknowledge that intellectual capital is one of their most important assets, as it is often the key to future growth and profitability.

Asset is used here in a generic sense. Knowledge and experience are embodied in people and are owned by them. It has been observed that:

> *Structural capital consists of everything that remains when the employees go home: databases, customer files, software, manuals, trademarks, organization structures and so on – in other words, organizational capability.*[52]

A report recently published by the Commonwealth Department of Industry Science and Resources comments that conventional accounting systems and the system of national accounts used in all industrialised countries were developed for manufacturing economies where most wealth was in the form of property, plant and equipment. It notes that these conventional accounting models do not account for many "drivers of corporate success" in a modern knowledge-based economy and points to the consequential increasing irrelevance of conventional financial statements.[53] The latter statement was supported by an article in a recent edition of the US Journal of Government Financial Management, for example as follows:

> *One of the major limitations of the current financial accounting and reporting model is that we do not measure and report human capital on financial statements. Accounting for human capital will require the invention of innovative new financial and management accounting concepts as well as reporting practices.*[54]

The reasons that intellectual capital is not currently recognised in financial statements would be well appreciated within this Congress and reflects issues such as the fact that it is often produced internally rather than acquired in an arm's length transaction and that cost is often not an appropriate measure of value which itself is often subject to frequent change and is dependent on the value of related assets.[55] The following observation is also relevant:

> *Researchers and practitioners are of the opinion that the IC measurement system should use various measures: financial, non-financial, quantitative, qualitative, and process descriptions. The measurement system should give a broad insight into the value-creation capacity of IC, and this cannot be realised using one bottom-line figure.*[56]

In a recent survey, Professor Guthrie and Dr Petty examined the extent to which intellectual capital is reported in Australian annual reports. Their survey indicated that no company reported intellectual capital in a satisfactory manner[57]. Internationally,[58] there have been moves towards measuring an organisation's intellectual capital. Intellectual Capital Statements are forming a part of annual reports in an effort to communicate the value of knowledge to an organisation. The form of Intellectual Capital Statements is not as precise measures but as collages that explain knowledge management strategies and activities.

One such example of an Intellectual Capital Statement is the intangible asset monitor. The intangible asset monitor aims to value human and structural capital. It is divided into three categories:

- *individual competence* – people's capacity to act in certain ways;

- *internal structure* – consisting of a wide range of patents, administrative and information technology systems, concepts and models created by employees; and

- *external structure* – relationships with customers and suppliers.[59]

Skandia, a well known Swedish insurance and financial services firm, has for several years been producing an annual report on its intellectual capital, released publicly, which measures the knowledge assets of one of its divisions. The report examines the impact of human capital, the knowledge, skills and innovative potential of workers and attempts to gauge, by the use of ratios and trend lines, how effectively these assets have been leveraged.[60]

So too Australian businesses are starting to acknowledge the important role that intellectual capital plays in their company's success. Information on intellectual capital has recently been included in the annual reports of several large Australian companies such as AMP, Lend Lease and Morgan & Banks. These organisations use a variety of intellectual capital reporting tools such as the Balanced Scorecard and the Intangible Asset Monitor[61].

Given the significance of intellectual capital to them, is this an area which should be considered for government reporting? If so, the impact is likely to be significant and important for public sector decision-making and any related inputs by citizens, individually or collectively.

7. CONCLUDING REMARKS

The uncertainties, inconsistencies and inherent limitations of financial statements discussed in this paper could be seen to imply that the efforts (and costs) of governments in implementing such reporting have not been effective. I would argue that this is not the case, although most would acknowledge that more could be done. Whole of government reporting can contribute to our understanding of governments' performance. It gives a valuable insight into the financial operations and, provided accounting policies are fully disclosed and consistently applied, also gives a useful overview of a government's financial position and the impact of a government's policies and actions on this position over time. In this respect, it supplements the more detailed performance information provided within the financial statements of individual entities and budget related documents produced by public sector agencies and by government.

Undeniably therefore, such information is important and should be available to the general public. However, suitable explanations should also be provided to ensure appropriate interpretation of the various accounting and other measures is possible, particularly on trends over time. In my view, it is important to achieve maximum harmonisation of concepts and standards between the public and private sectors and internationally. However, the basic distinctions need to be recognised and treated openly and simply. This would assist all stakeholders, not least of all the general public.

A wider issue is how financial statements can remain relevant when they fail to address questions such as the government's impact on the environment, the quality of assets provided to the community by the government and the intellectual capital available to the community from within government.

Emerging developments such as triple bottom line reporting and the reporting of intellectual capital take us a lot further than where we are today. Governments and their accountants can ignore these latter developments in favour of the more limited picture provided by traditional financial reporting models, or they can take a leading role in their implementation. Indeed, some major private sector corporations are taking a lead in this direction as indeed are some local governments.

Despite governments' late start in the accrual environment, it might be time to take a more complementary role in making financial statement reporting more meaningful and useful in these wider respects. It would obviously be better to anticipate, rather than react to, user demands in the interests of greater accountability for performance as required of a more responsive public sector. The imperative is to be clear as to what purposes consolidated government financial statements are meant to serve. There is no doubt we can, and should, improve their usefulness in coverage, consistency and simplicity. This is as much a challenge for the profession as it is for account preparers and auditors.

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> In the Report, the SA Auditor-General himself examines some of the trends emerging in the financial situation of the SA Government. For example, at pp61 *et seq*, he examines emerging trends in State Debt, unfunded superannuation and other liabilities against targets set by Government, including, for example, the elimination of unfunded superannuation liabilities by 2034.

[9] Commonwealth of Australia, 2001, Committee Hansard, Joint Committee of Public Accounts and Audit, *Review of the Accrual Budget Documentation,* 22 June, pp. 6-7.

[10] Levitt Arthur, 1999 *Corporate Governance in a Global Arena,* Remarks to The American Council on Germany, New York, 7 October, p. 4.

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[12] Commonwealth of Australia, 2001, Committee Hansard, Joint Committee of Public Accounts and Audit, *Review of the Accrual Budget Documentation*, 22 June, p. 13.

[13] Newberry, S. 2001. *Public Sector Accounting: A Common Reporting Framework?*. Department of Accounting, Finance and Information Systems, University of Canterbury, New Zealand, Australian Accounting Review, Issue 23 Vol 11 No 1. March.

[14] Australian Accounting Standards Board, 1992 Statement of Accounting Concepts, SAC4 *Definition and Recognition of Elements of Financial Statements,* Melbourne

[15] Budget papers anticipated a 30 percent increase in company tax, as a result of strong company income growth and the introduction of the PAYG system, which effectively brought tax assessments forward into 2000-01. Refer Budget Paper No 1 – Budget Strategy and Outlook 2000-01. pp5.7 and 5.11. The Final Budget Outcome states that taxation cash receipts were in fact even higher than expected at Budget time due to fewer companies choosing to defer payment under the transitional provision laid down for the movement to the PAYG system. Refer Budget Outcome 2000-01, p.1.

[16] Commonwealth of Australia, 2000. *Budget Paper No 1*. Statement S: Revenue, Table 6, p.S-13.

[17] Commonwealth of Australia, 2001. *Final Budget Outcome 2000-01*, p.1-9.

[18] The Final Budget Outcome does not show the GST as Commonwealth revenue. However, Government Finance Statistics tables in part 2 show GST as ‘revenue in’ and GST grants as ‘expenses out’. Refer to Final Budget Outcome 2000-2001 Tables 7-9 pp.16-18.

[19] See *ABS Information Paper: Accruals –Based Government Finance Statistics 5517.0 2000*. The paper discusses the application of guidance and five specific rules found in the International Monetary Fund's *A Manual on Government Finance Statistics (1986)* to the treatment of the GST. The analysis concludes "the Commonwealth exercises considerable influence and discretion over the setting of the GST and the distribution of its proceeds. It also suggests that, individually, the States and the Territories do not have sufficient influence or discretion over the setting of the GST or the distribution of its proceeds. GST revenues will be distributed in accordance with Commonwealth Grants Commission fiscal equalisation principles in a similar manner to that already applied in the distribution of income taxes. This situation does not fit the IMF guidelines relating to the attribution of tax revenues to beneficiary governments, which means that GST revenues should not be treated as individual State or Territory tax revenue."

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