

CPA Australia
Public Sector Finance and
Management Conference

**Financial Management in the
Public Sector**
*How accrual accounting
enhances governance and
accountability*

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Ian McPhee
Auditor-General for Australia



Introduction

Thank you for the invitation to present a paper today on the role of accrual accounting and how it enhances governance and accountability.

I propose to traverse some history in making the case that accrual accounting and budgeting has played its part in better informing those who carry responsibility for management decisions, as well as stakeholders, on the financial performance of Australian Government entities and the government as a whole.

Background

Accrual accounting and budgeting in the public sector has come a long way in a relatively short period of time. It was less than 15 years ago – in November 1992 - that the Australian Government public sector departments and agencies (agencies) moved to adopt accrual accounting. Prior to that, they had presented modified cash accounts. All statutory authorities have reported on an accrual basis since 1986, although some reported on this basis prior to this time.

The adoption of accrual reporting for agencies was a big decision at the time, because it marked a recognition that the traditional approach to accounting and reporting had its limitations. At the time, budget accounting ruled supreme and the emergence of accrual accounting concepts was not universally warmly embraced.

Accrual accounting, and then accrual budgeting, were important elements in a suite of public sector reforms directed to improving the efficiency and responsiveness of government services, and enhancing the accountability for the use of public resources.

There were then, as there are today, discussions around the application of the accrual concepts to the public sector. Governments have fundamentally different roles to enterprises in the private sector, and so direct translation of the private sector model was not then, and is not now, the right answer. For example, governments have different objectives to private sector entities, generally acquire assets to provide service potential rather than to generate future cash flows, and have a range of social obligations beyond those of private sector entities.

So some of the traditional accounting concepts need additional consideration, and, in some cases, modification, for application in the public sector environment. The presentation of information to meet the needs of public sector users is another consideration.

In the early years, recognising there were unresolved issues and less than full acceptance of the benefits of accrual accounting, the then Department of Finance (Finance) adopted an incremental approach to the expansion of disclosure requirements relating to assets and liabilities in agency financial

statements. In this way Finance conditioned public sector agencies to a more comprehensive basis of reporting. Even when it was decided by the Finance Minister in 1992 to adopt full accrual reporting, agencies were allowed several years to produce their first set of accounts on this basis. As it turned out, 10 agencies reported on an accrual basis in 1992–93, approximately 20 in 1993–94 and the remaining agencies in 1994–95. The first accrual based ‘whole of government’ statements that were audited were for the 1996-97 financial year, and followed a two year trial period when unaudited financial statements were published.

The Organisation for Economic Co-operation and Development (OECD) completed a study of the use of accrual accounting in the public sector at the time (in 1993), and referred to the benefits which accrual accounting can provide to public sector entities, including the ability to:

- Reflect and provide the basis for accountability for the additional flexibility provided to public sector managers;
- Underpin objectives for a more competitive approach to public sector provision;
- Facilitate more efficient and effective resource management;
- Improve accountability by extending the notion of performance beyond the use and application of cash; and
- Provide a longer term focus on the effect of government and management decisions.

These benefits hold true today.

The most significant step, though, in cementing the benefits of accrual accounting, was in the adoption of accrual budgeting; which occurred in 1999 – 2000. The National Commission of Audit, which conducted a review in the early days of the first Howard Government, recommended the adoption of *‘accrual principles as the basis for an integrated budgeting, resource management and financial reporting framework (which would include cash flow reports), both at the agency level and at the aggregate budget sector level,¹⁷* but it took the drive and determination of the then Finance Department, supported by public sector agencies, to deliver on this major reform.

This was a very substantial change, not without its wrinkles, but a major achievement in linking financial reporting to the Budget, which was the engine of financial management reform. The Budget is, and has always been, such a powerful driver for change in the Australian Government public sector that accrual accounting would always have been a backroom exercise without accrual budgeting.

It was significant also that the two most influential committees of the parliament in terms of financial management, namely the Joint Committee of Public Accounts, and the Senate References Committee on Finance and Public Administration, were supportive of the adoption of accrual concepts in government accounting and budgeting.

We need to recognise that in the context of the accrual budgeting and accounting model we have today, and as envisaged by the National Commission of Audit, information on cash is still very important, particularly in terms of Government decision-making. There is no denying the Budget surplus/deficit line of the Budget Papers and financial reports is still the most quoted measure as an indicator of government financial performance. At the last election, the major political parties committed to running budget surpluses (underlying cash) – this was the key measure.

Assessing the contribution of accrual accounting and budgeting to enhanced governance and accountability.

It is the case that accrual information provides better information for decision making and accountability purposes than earlier financial information available to managers, government and the Parliament.

In our devolved system of public administration many of the practical benefits from accrual budgeting and reporting has been derived by agencies. By flushing out the real costs of operations and resources tied up or committed, agencies are better placed to manage programmes efficiently and effectively.

By analysing prospective transactions in the light of the accounting framework, accountants in agencies are able to contribute to a more informed understanding of the transactions. This may include understanding the level of risk being taken by the Commonwealth or being more focussed on the probability that future economic benefits will flow to or from an agency as a result of transactions or events. Accounting advice can inform decisions across the spectrum, including in relation to revenue or expense recognition, grant administration, and asset and liability management. For example, changes in the carrying value of key assets and liabilities due to impairment or revaluation, can provide important information to management, which may, in turn, influence strategies being adopted by an agency.

At another level, difficulties in applying accounting standards will often point to underlying systems issues. Such issues in turn are likely to be indicators of sub-optimal management of a particular programme or function, with the costs being carried by taxpayers.

In this light, accrual budgeting and accounting isn't just about recording the debits and credits – it is a discipline which aids management to better understand and govern their programme and organisation. It is a means to an end.

Now there is always room for debate at the margin, of the merits of particular accounting standards or disclosures – that is another issue – but I am in no doubt that public administration is better informed as a result of the accrual accounting and budgeting reforms. Viewing accounting information as performance information to be interpreted with other key performance

indicators, establishes the right tone and context for any organisation, and for government as a whole.

Against this background, it is apparent we are seeing a shift in the use of accounting information – from being a requirement for financial reporting purposes, to being a useful additional source for managers and ministers to aid decision-making. This trend is moving in the right direction.

As the reforms have changed financial reporting and resource management, we have seen the rise and rise of the CFO function, and the role played by CFOs on management boards to inform the debates within agencies on both policy and operation. And not just the CFO function. We commonly see today accountants in operating divisions contributing to better performing programmes.

I am not suggesting that accountants can claim all the credit in this space, but that they have contributed positively to the decision-making, both at the agency level and in informing government on policy options.

Some public sector agencies still have work to do in better integrating their business and accounting systems, and streamlining their financial statements preparation processes. ANAO reports have referred to some of our major agencies and issues relating to:

- having appropriations or authorisations in place to cover planned expenditure;
- performing key reconciliations to provide assurance around the integrity of information being reported;
- paying close attention to material and unusual transactions;
- addressing access security within FMIS's and HRMIS's.
- underpinning the financial statement preparation process with effective project management arrangements, including aligning monthly financial reporting process with year-end processes to the extent practicable;
 - in this context, the work done by Finance and agencies generally on the implementation of AEIFRS's has been beneficial as significant issues that have arisen to date have been resolved without impacting on reporting timetables.

The ANAO has recently issued a Better Practice Guide on the *Preparation of Financial Statements by Public Sector Entities* to assist agencies and their audit committees to enhance their preparation and accountability processes for agency financial statements. There is still room for greater discipline to be applied to the end-of-year and end-of-month processes by many agencies. In this context, agencies are able to benefit from others' experience in streamlining their own approaches and practices.

Beyond the 'accounting' dimensions to the CFO role, the real growth area that I see going forward is the CFO's contribution to the information and analysis for determining policy and organisational strategies, to monitor and manage performance, and to aid in embedding these cultures within agencies. To be

credible on these fronts, though, requires a sound basis for accounting and financial reporting.

At a government level, historically the more comprehensive reporting has tended to reflect a stewardship role - we have a full set of financial reports prepared for the:

- Australian Government General Government Sector;
- Australian Government Public Non-financial Corporations;
- Australian Government Public Financial Corporations; and
- Australian Government Consolidated Financial Statements

There are now signs of key departments and government taking advantage of the more comprehensive information provided to them and to the Parliament.

Dr Ken Henry, Secretary to the Treasury, in a presentation last year ² on *'Managing macro risks in the general government sector'* identified 3 key macro risks, including:

- Government, as risk manager of last resort;
- Management of the general government balance sheet; and
- Operational risks associated with preparation of the annual Budget.

The reference to management of the general government balance sheet is important, because it shows a focus on the financial position of the Commonwealth, not just the more traditional budget measures, and illustrates the value of the more comprehensive information brought about by accrual accounting.

Other recent examples relate to superannuation – a liability of \$91 billion as at 30 June 2005³. Superannuation is now the single largest liability on the Australian Government's balance sheet. Many people at this conference have more than a passing interest in this liability, which is measured on the basis of the present value of the Australian Government's contractual liability under its various superannuation schemes for past services as measured by the actuaries to the respective schemes.⁴

The superannuation liability has received more attention than the associated cash flows in recent years. It was not so long ago, though, that officials briefed Ministers to the effect that this liability was best met on an emerging cost basis, as it had always been done. However, the stronger balance sheet focus has led to three quite significant decisions by government that are directed to managing the superannuation liability.

The first covers the announcement in October 2003 ⁵, that the Public Sector Superannuation Scheme would be converted from a defined benefits scheme to a fully funded accumulation scheme for new members from 1 July 2005. Under the new arrangements, the Government contributes 15.4% of salary for employees under these arrangements to fully meet its superannuation obligations rather than just pay for the emerging costs.

The second concerns the decision announced in the 2004-05 Budget⁶ to pay out the Government's superannuation liabilities to the Telstra and Australia Post Superannuation Schemes relating to former employees by making lump sum payments rather than the traditional quarterly instalments that commenced in 1990. That decision resulted in a \$4.7 billion reduction in the Government's unfunded superannuation liability and, of course, reducing the Government's superannuation expenses in the out years, partly offset by the financing costs associated with making the payments. Overall, there will be an improvement in the fiscal balance going forward because the transaction paid out a high cost liability, with interest tied to the investment returns in these funds.

The third important decision announced in the 2005-06 Budget⁷, concerned the establishment of the Future Fund to meet the Government's remaining unfunded superannuation liabilities. The Future Fund has been established to accumulate sufficient financial assets to offset the superannuation liabilities by 2020, by investing future Budget surpluses in the Fund. The other benefit of this approach is that it keeps Australia's debt market afloat despite the running of Budget surpluses, and provides a debt market benchmark.

This focus on the superannuation liability illustrates how greater visibility of the Government's balance sheet, combined with a strong economy, potentially offers a more informed range of policy options for Government to consider in determining its fiscal strategy and budget priorities.

Overall, the Government's General Government Sector (GGS) and Consolidated Balance Sheet continue to strengthen. The forecast GGS net worth is expected, on current policy settings and assumptions, to be positive by 2008-09⁸ and the CFS financial position to show positive net assets before then due to the positive contribution by the public corporations. That said, in the public sector it is particularly important to understand that the role of Government is unique and, while there are now greater efforts to manage the Government's balance sheet, it will continue to be a derivative of the Government's medium-term fiscal strategy, which is directed to:

- maintaining budget surpluses over the forward estimates period while growth prospects are sound;
- not increasing the overall tax burden from 1996-97 levels; and
- improving the Australian Government's net worth position over the medium to longer-term.

We also need to understand the boundaries of information that is presented in a public sector balance sheet. We do not, for example, accrue any liability for the age pension beyond 30 June, even though we know there is a percentage of the current population who will continue to receive the pension for many years to come. The Australian Government is required to publish, every five years, an Intergenerational Report⁹ to highlight, amongst other things, various factors that may significantly affect Australia's fiscal position. The increasing costs of the ageing population are particularly important in this context and I

would anticipate, in the years to come, there is likely to be stronger bridges between current financial reporting practices and the reporting of some of the obligations and responsibilities which governments have, but which do not have a parallel in the private sector.¹⁰ This highlights that we still have a range of public sector accounting issues that we need to grapple with.

Even at the agency level, there are issues which are not that settled. Pat Barrett¹¹ in a paper two years ago, referred to comments by Professor Barton and the Inspector-General of Intelligence and Security to make this point.

“Professor Barton uses the Department of Defence in his article *The Department of Defence – Australia’s Most Profitable Business?*¹² as an example of the apparently misleading nature of departmental financial statements, if considered in a private sector context. For the year ended 30 June 2002, the Department of Defence reported total revenues of \$18.99bn, a surplus \$4.41bn, capital-use charge paid \$4.6bn, net assets and equity \$45.59bn (comprising capital contribution \$1.3bn, asset revaluation reserves \$6.2bn, and retained surpluses \$38bn). On these figures, the Department appears to be a highly profitable enterprise – it generated a surplus of 23% on revenue, 340% on contributed capital and 9.7% on total equity. As well, it appears to be largely self-funded, as the asset revaluation reserve and retained surpluses contributed 97% of total equity.¹³

Given the nature of the department’s activities in providing defence services to the nation, and its reliance on budget appropriations to fund its activities, Barton raises the question ‘how can Defence have such an impressive financial performance and strong financial position?’¹⁴ His major point is expressed as follows:

*‘..the department’s financial statements do not faithfully report the reality of its financial operations even though they fully comply with Australian Accounting Standards (AAS) and government accounting requirements...the problems arise from ..having to operate as if they are pseudo-businesses under the New Public Management reforms which include using business accrual accounting standards’.*¹⁵

This view also created some resonance from a small agency perspective. The previous Inspector-General of Intelligence and Security (IGIS) argued that current reporting requirements for government agencies ensured ‘no-one can understand the reports’ except the accountants who produced them. The Office of the Inspector-General of Intelligence and Security (IGIS) is quite small. It has a full-time staff of four and an annual budget of about \$700 000.¹⁶ The Inspector-General’s comments stem from the application of the full force of the public sector accounting reforms. These include accrual accounting, and the many pronouncements of Australian Accounting Standards Boards. Another academic commentator observed that ‘The financial statements that emerge from this cocktail are unedifying’,¹⁷ and he went on to draw the conclusion that:

The application of a business accrual model to a government funded body like IGIS is inappropriate. It leads to IGIS masquerading as if it was a legal entity in the private sector. It reports revenues from the sale of its services to government of about \$700 000 and an operating surplus (or profit) of \$66 719. But IGIS is not a private sector business and shouldn’t account as if it was. IGIS provides non-commercial public goods to government for defence intelligence-related purposes in a competitor-free environment. It is funded from an appropriation by government based on the cost of the services it provides....The operating surplus or profit (\$66 719) is a contrivance for IGIS or any agency like it. While businesses in the private sector must produce a profit to survive, there is no such imperative for IGIS .”

The road ahead

As you will have gathered, I am a strong supporter of the changes that have occurred in public sector accounting to aid decision-making and accountability. But we aren't there yet, because there is still a range of public sector specific accounting issues yet to be resolved. And we have quite a confusing range of reports produced for government, Parliament and the general public.

I have mentioned earlier further work that could be done on accounting for the social policy obligations of government. There is also work underway or scheduled by the AASB to clarify accounting for administered items, non-exchange revenue, and heritage assets.

In the Budget papers, there are at least three different forms of budget presentations, largely focused on the General Government Sector, namely:

- The budget financial statements based on Government Finance Statistics (GFS), but with some GFS departures (including the accounting for the GST) ;
- The GFS statements (including GST as revenue); and
- The Australian Accounting Standards (AAS) financial statements (excluding GST as revenue).

We also have two main reports showing the outcome for the year:

- the Final Budget Outcome, which comes out in September, essentially mirroring the Budget presentation; and
- in November or December each year, the Consolidated Financial Statements for the economic entity which is the Australian Government (including, for example, a consolidation of Telstra's accounts), are prepared on an AAS basis.

So not only do we have the different forms of presentation, but there are different accounting bases – Government Finance Statistics and Generally Accepted Accounting Principles. It takes quite a deal of knowledge to understand what all these reports mean. Throw in some of the changes being brought about by AEIFRS, and we have quite a kaleidoscope of figures and form.

Against this background, it is encouraging that the Australian Accounting Standards Board is working on the project to harmonise GFS and GAAP for the General Government Sector following the receipt of comments on the earlier exposure draft of the standard. This will contribute significantly to a better informed constituency and, as a result, provide a better basis for holding governments to account. This is one of the last frontiers in public sector reporting, and whatever compromises may need to be made along the way will be worth the result. Ideally, we would also see some alignment between this new report and the Consolidated Financial Statements, so users can be aware of the key differences between the General Government Sector

and the Consolidated Financial Statements, and be able to navigate between the two reports.

Conclusion

Accrual accounting and budgeting have made a significant contribution to public sector administration. We may not have solved all of the public sector accounting issues, nor have some of the systems and processes been running as smoothly as we may have liked, but a lot of progress has been made in a relatively short period of time.

From my perspective, the real benefits of the more comprehensive information have been at the organisational level. This is because agencies have the benefit of information relating to their own operations and programmes administered by them. This aids decision-making by agencies in respect to their own operations, but also allows policy advice to be better targeted because the cost or revenue dimensions of options are better understood.

In the last few years though, we are seeing signs of the Australian Government balance sheet being managed rather than perhaps being seen solely as a stewardship report. The recent decisions relating to public sector superannuation reflect this.

These developments have contributed to more informed policy choices, stronger performance and a more comprehensive basis for accountability.

We should not overlook that the accounting and budgeting changes have been part of a much wider movement to improve the efficiency, effectiveness and accountability of the public sector.

In closing, it is important to recognise the role of the accounting profession in Australia, of which CPA Australia has been a key contributor, in progressing the development of the suite of public sector standards and promoting the benefits of better information for decision-making in government.

Thank you.

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- ¹ Officer, Robert, Chairman, 1996, *National Commission of Audit – Report to the Commonwealth Government*, Department of Finance, June 19.
- ² Comcover's fourth Annual CEO Forum, September 2005
- ³ The size of the superannuation liability under AEIFRS is at least \$8.4 billion greater than this given that the Department of Finance and Administration disclosed in their 2004-05 financial statements (Note 2) this impact in relation to the schemes administered by the department.
- ⁴ Consolidated Financial Statement for the year ended 30 June 2005, page 157.
- ⁵ Portfolio Additional Estimates Statements 2003-04, Finance and Administration Portfolio, p17.
- ⁶ Budget Paper No 2, *Budget Measures 2004-05*, page 179.
- ⁷ Budget Paper No 1, *Budget Strategy and Outlook*, page 1-15
- ⁸ Budget Strategy and Outlook 2006-07, Budget paper no 1, 9 May 2006, page 7-4
- ⁹ *2002-03 Budget Paper No 5 Intergenerational Report 2002-03*, 14 May 2002,
- ¹⁰ The Intergenerational Report also highlights that, under current policy settings, Commonwealth revenue is expected to exceed spending until about 2017, 2018, but after that, spending is expected to exceed revenue with the gap expected to grow to 5% of GDP if policies are not adjusted, by 2041-42 (or some \$87 billion in 2002-03 dollars).
- ¹¹ Barrett, Pat, 2004, *Financial Management in the Public Sector – How accrual accounting and budgeting enhances governance and accountability*, 21 August, found at www.anao.gov.au
- ¹² Barton Prof Allan, 2003, *The Department of Defence – Australia's Most Profitable Business?*, Australian Accounting Review, Vol 12, No 2
- ¹³ Barton Prof Allan, 2003, *The Use and Abuse of Accounting in the Public Sector Financial Management Reform Process*, National Institute of Economics and Business, Public Lecture, 4 June, pp17-18
- ¹⁴ Barton Prof Allan, 2003, *The Department of Defence – Australia's Most Profitable Business?*, Op cit p.35
- ¹⁵ Ibid p.35
- ¹⁶ Craig, Russell, 2002, *A Case of accounting overkill?* April, p.1, found at www.cpaaustralia.com.au/_publications/02
- ¹⁷ Ibid p.1