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**OCCASIONAL PAPERS ON  
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**ACCOUNTING FOR WHAT?:  
THE VALUE OF ACCRUAL ACCOUNTING TO THE PUBLIC SECTOR**

**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

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## **This Report**

There is growing recognition that public sector entities should be accountable for more than cash flows and balances. This has been reflected in the introduction in many OECD Member countries of public management reforms which emphasise the cost effectiveness of activities, and which incorporate a range of incentives to encourage better management, provide greater flexibility in the allocation of total resources, and which stimulate a focus on value for money.

Within this framework, financial accounting and reporting systems are seen to have an important role to play in providing necessary information to support decision-making, and to reflect accountability in value for money terms. Public sector reforms have implied the need to enhance accounting and financial reporting beyond cash considerations alone to encompass accounting and reporting on the allocation and use of total economic resources (both cash and non cash) at the disposal of managers. They have thus implied the need for some form of accrual accounting. Interest has also centred on the potential for this form of accounting to enhance decisionmaking and control over the long term financial consequences of government policies.

This Occasional Paper brings together the experience of five OECD countries who either have introduced or are introducing some form of accrual accounting into their public sectors. In an effort to draw conclusions on the degree to which accrual accounting may be useful in the public sector, the paper clarifies the relationship between accrual and traditional cash based methods of accounting; outlines the rationale underlying the expanded use of accrual accounting in the public sector; and, identifies the conditions and risks related to the design and implementation of such arrangements in relation to public sector activities.

The report was prepared as part of the OECD Public Management Committee's (PUMA) activity on budgetary resource allocation and control. The paper was considered in, and reflects the outcome of, a meeting of Senior Budget Officials from OECD countries in June 1993, conducted under the auspices of PUMA. Specific country information contained in the document is correct as of that date. The report was prepared by Terry Wall of the Public Management Service. The author would like to thank officials from Australia, Iceland, New Zealand, the United Kingdom and the United States for their help in compiling information on their country's practices.



## **PART I SYNTHESIS REPORT**



## **I. INTRODUCTION**

Accrual accounting is beginning to generate interest in terms of its potential to contribute to improved public management and public sector performance. At a Meeting in 1992, Senior Budget Officials from OECD countries expressed interest in the Secretariat undertaking work on the nature and extent of use of accrual accounting practices in the public sectors of OECD Member countries. The focus of interest for most countries was in finding out what others are doing in this field and how it is progressing. The motivation for interest in this subject derived from its linkage in some countries to reforms to the public sector aimed at developing a more corporate approach to management and a focus on outputs and outcomes.

Accrual accounting has been a common feature of budgeting and financial reporting requirements established for the commercially competitive parts of the public sector. Its application to the "core" (budget dependent) elements of the public sector is of more recent origin and is the main focus of this paper.

This report attempts to synthesise current thinking on the manner and extent to which accrual accounting might contribute to the objective of more cost effective management of the "core" public sector. It draws on the experience of five OECD Member countries who have either implemented or are implementing accrual based accounting and reporting arrangements. Details of country practices are contained in Part II of the report, and we thank our colleagues in Australia, Iceland, New Zealand, the United Kingdom and the United States for their help in compiling them.

The remainder of Part I is structured as follows. First we clarify what is meant by the terms cash and accrual accounting. These accounting bases have often been viewed as mutually exclusive. This section suggests they should, more appropriately be viewed as end points on a spectrum of possible accounting bases ranging from full cash at one end to full accrual at the other. Where countries lie on this spectrum should ideally reflect decision-making and accountability needs.

Section 3 draws on country experiences in order to formulate conclusions on the reasons justifying application of some form of accrual accounting to the "core" public sector. It identifies the range of financial information requirements which countries have identified as necessary to meet user needs and outlines the potential benefits which accrual accounting arrangements can bring to bear in meeting those needs.

Section 4 addresses questions of implementation. It suggests that on the basis of country experience, the manifestation of potential benefits from accrual accounting systems will depend importantly on the approach taken in implementation and on meeting a number of related conditions. These are identified and country experience in dealing with them outlined.

Finally, on the basis of recent, limited experience some general conclusions are offered on the value of accrual accounting to the public sector.

## **II. ACCOUNTING AND REPORTING BASES**

Cash and Accrual accounting represent two end points on a spectrum of possible accounting and financial reporting bases. Cash accounting recognises transactions when cash is paid or received which need not be related to the timing of the services provided or benefits received from transactions. Financial results are reported on the basis of differences between cash received and cash paid. Information is provided on the sources of cash receipts and uses to which funds were applied during a reporting period. Cash accounting has traditionally been the basis upon which most public sector entities have accounted and reported, largely reflecting the benefit this method has in demonstrating compliance with (cash) spending

limits; this being the basis upon which governments have traditionally budgeted and upon which public sector entities have generally been held accountable.

Accrual (or comprehensive) accounting recognises transactions or events when they occur irrespective of when cash is paid or received. It seeks to match the costs incurred during a particular accounting period with the benefits earned, and revenues with goods or services provided. These transactions may take place independently of cash transactions but may also include cash transactions. The elements of accrual based accounting and reporting regimes comprise revenues, representing amounts earned during the period whether or not collected; expenses, comprising the goods or services consumed during a period, irrespective of whether or not they have been paid for; assets representing resources controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity; liabilities representing future obligations of the entity arising from past events settlement of which is expected to result in an outflow from the enterprise in the future of resources embodying economic benefits; and equity representing the residual interest in the assets of an entity after deducting all liabilities.

The relationship of revenues and expenses enable the determination of profit (in the case of business oriented activities) or permit assessment of the net cost of providing services (in the case of non-profit organisations). Differences between the timing of recognition of revenues and expenses and cash transactions give rise to assets (future economic benefits) and liabilities (future outflow of economic benefits) which are capitalised as revenues and expenses in the periods in which they actually occur. The most common of these are depreciation charges raised on the use of capital assets. The relationship between assets and liabilities enables assessment of an entity's financial position.

Generally, the accrual basis of accounting and reporting is recognised as useful in providing information on matters such as the resources controlled by an entity, the full cost of operations (or of providing services) and the assessment of economy and efficiency of operations.

However, within these "extremes" there are numerous arrangements which can be put in place to modify pure cash or pure accrual accounting systems, in order best to meet the accounting and reporting objectives of an entity. Such adaptations may include, for example, the recognition of both cash and cash obligations by holding the books of account open at the end of a financial year to record transactions which will involve the receipt or expenditure of cash within a specified period after the end of a financial year. Similarly, modifications to the full accrual basis of accounting may involve the reporting of financial assets and liabilities only or may include the limited disclosure of certain assets and liabilities (both physical or financial).

Whatever the precise method of accounting chosen, or its situation within the spectrum of arrangements between full cash and full accrual accounting, there is general agreement that the primary aim of any accounting and reporting system should be to provide information useful for decision-making as well as best to meet the need for accountability for resources (however defined).

### **III. WHY ACCRUAL ACCOUNTING?**

Debate about the merits of applying accrual accounting to the public sector have tended, in the past, to concentrate on the inherent differences in the nature of public and private sector activities.

The appropriateness of accrual accounting for business enterprises in the public sector has generally been accepted by all. Perceived benefits derive from relative independence in management and control of operations afforded to these bodies; the commercial nature of their operations; the need to establish accountability for total resource use; the ability to assess performance and financial position in commercial terms and at a strategic level. Profitability is an important measure of the success of these entities. It demonstrates the ability to control aggregate costs and for individual projects and activities, in

relation to revenues generated through sales. It demonstrates effective demand for the entities activities and is a measure of continued viability. Financial position (as reflected in a balance sheet of assets and liabilities) provides information on the degree of likely future vulnerability, solvency and capacity for adaptation. All of the countries in this study who have entities operating along commercial lines have favoured the adoption of accrual accounting for many of these reasons.

Historically there has been less consensus on the merits of introducing accrual accounting to the "core", budget dependent, elements of the public sector. Profit is generally not an objective nor a measure of performance for core public sector activities; rather the aim is to deliver goods and services consistent with government policy. Performance in this context needs to be judged on a wider set of criteria than financial tests of success or failure. Revenue is not (at least not in the main) derived from sales, but flows from appropriations, through the exercise of powers of taxation. The ongoing viability and solvency of public sector activities is determined by the will of government to continue funding rather than the ability of an entity or service to earn net returns. Future vulnerability is not a function of the financial structure of these activities, but is more dependent upon the success of programmes and activities in meeting the policy objectives set for them by governments. Capacity for adaptation is not relevant as entities may not be permitted the flexibility to buy and sell assets on their own behalf, nor are they at liberty to change the nature of their activities. The paramount objective for accounting systems for the core public sector has thus been traditionally viewed as the control of cash spending in accordance with Parliamentary limits.

Recent interest in extending accrual accounting and reporting arrangements to core public sector activities has attempted to move debate on from considerations relating to the relative roles of the public and private sectors and the merits of one or other form of accounting. It is aimed at tailoring accounting and financial reporting to the specific conditions of the public sector by addressing the question "What is the most appropriate accounting and reporting framework to meet the needs of users of financial information given the performance and accountability requirements currently applicable to the public sector environment?".

In seeking answers to this question countries have recognised that changes in the manner in which the public sector is organised and managed have called into question accounting and reporting of cash transactions alone. All of the countries reviewed in this Study have either implemented or are implementing public management reforms which emphasise the outputs and results of activities (as opposed to compliance and limits on cash inputs). Reforms incorporate a range of incentives to encourage better management and provide greater flexibility in the allocation of economic resources so as to stimulate a focus on value for money. Work undertaken in Australia, the United States, and more generally <sup>1</sup>, to define the objectives of accounting and financial reporting in the public sector has suggested a range of information needs which governments need to address. Depending on the characteristics, nature and objectives of public sector entities and their accountability relationships, the objectives of accounting and financial reporting are seen to require information useful to decisions on <sup>2</sup>:

- . Stewardship and Compliance to assess: whether resources were obtained and used in accordance with legal constraints and contractual requirements; and stewardship over the custody and maintenance of resources (both financial and physical).
- . State of Finances, to assess: sources and types of revenues; the allocation and use of resources including the split between operating and capital costs; the extent to which revenues sufficiently cover costs of operations (including non cash costs); the timing and volume of

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1. International Federation of Accountants (IFAC) - Public Sector Committee.

2. Source IFAC - Public Sector Committee Study No. 1 - Financial Reporting by National Governments.

cash flows; the ability to meet financial obligations both short and long term; and, to assess overall financial condition.

- . Performance, to assess: the economy and efficiency of operations and whether goals and objectives have been met.
- . Economic Impact, to assess: the economic impact of the government on the economy; and to enable evaluation of government's spending options and priorities.

There is similar agreement that for financial systems to be effective, the information they produce must be reliable; relevant to the needs of users; understandable, clear and precise; timely; and consistent over time.

Cash accounting cannot meet all of these objectives. While its advantages are acknowledged in terms of assessing (short term) economic impact and compliance with spending limits, its ability to inform decisions on stewardship and the state of finances is constrained to consideration related to cash resources and exclude physical and financial assets and liabilities. Alone, it provides no basis for judgements on performance in terms of economy and efficiency, nor on the achievement of goals or objectives.

It seems clear that, to the extent the nature of accountability within the public sector shifts from a relatively narrow focus on compliance with spending limits, to embrace accountability for the outputs, efficiency and results of activities; to encompass concerns with the full costs of operations; or to reflect longer term obligations and overall financial condition; so accounting and financial reporting systems need to adapt to reflect these requirements. Accounting and reporting practices must move along the "spectrum" to encompass elements of accrual accounting. Precisely how much accrual accounting countries should embrace should be directly related to the nature of the performance and accountability objectives they seek to address.

The countries represented in this study have attempted systematically to assess the financial information needs which give effect to revised decision-making and accountability structures. No country is considering dispensing with cash reporting. Rather, work has focused on the additional financial information necessary to complement traditional cash budgeting so as to reflect the new performance challenges and priorities facing their public sectors.

In New Zealand, resolve to improve the cost effectiveness of the public sector involved a comprehensive reassessment of the nature of accountability and the information (including financial information) necessary to reflect what was required by way of performance. Identification of Governments' interest as both owner of departments and purchaser of their outputs, and recognition of these as the means by which performance should be evaluated, had important implications for the basis for accounting and financial reporting. The government's ownership interest implied financial reporting along similar lines to the private sector so as to monitor performance of the government's investment. The purchase interest implied information similar to private sector sales contracts: quantity, quality, time and place of delivery, and price. Decisions about output pricing needed to be informed by data on total resource use not simply cash outlaid, which also implied accrual accounting.

In the United Kingdom, a focus on the value of money in the provision of public services was stimulated via the progressive introduction throughout the last decade of a range of reform initiatives. Many implied the need to refine existing and develop new financial management procedures and accounting arrangements to enhance decision-making on and accountability for value for money. Traditional focus on cash excluded from managers purview or control a number of non-cash resources relevant to achievement of the broader results oriented goals set for managers. Assessment of performance on the basis of value for money required financial information which showed how total resources were applied and managed in addition to information on cash payments and receipts. Accordingly, non cash items were brought into the

cash accounting system; supplementary accrual based information was produced; and, additional requirements calling for accrual based rather than cash based information were introduced. Elements of similar concerns and strategies have been evident in the underlying rationale for change in Australia.

In the United States and Iceland concern to control the nature and extent of long term (contingent) liabilities particularly in the form of loans, loan guarantees, and pensions stimulated a search for alternative (accrual) budgeting and reporting techniques which better reflected and enhanced decision-making on the magnitude of these accruing costs. Passage of the Chief Financial Officers (CFO) Act in the United States and similar management reforms in Iceland, which seek to focus on the efficiency and effectiveness of government programmes and activities, have added further impetus to developments.

Implicit in the arrangements introduced in all countries is the notion that there is a range of specific, incremental benefits conferred by accrual accounting vis à vis cash. These include:

- . reflecting and providing the basis for accountability for the additional flexibility which has been provided to public sector managers. Devolution of authority over resource allocation decisions and associated consolidation of (cash) appropriations has been an aspect of many countries' reform programmes (Australia, Iceland, UK). They have attempted to lift the sights of managers from cash control over inputs to focus on the best resource mix to achieve objective set for the outputs and efficiency of government programmes and activities. Accrual accounting is seen to provide a more accurate indication of the (full) cost of running departments and agencies and their programmes and thus enhances accountability for resource allocation decisions. This has been reinforced in New Zealand by altering the system of appropriations to an output (accrual) basis, incorporating full resource costs. Similar potential has been exploited in the revolving funds framework established for Trading Funds in the United Kingdom and in the requirements to attribute accommodation and superannuation costs to Departments and Agencies. It is further being examined in the context of considering appropriate definitions for Running Costs under the Resource Accounts proposal to be piloted in departments.
- . underpinning objectives for a more competitive approach to public sector provision. Accrual accounting is seen as necessary for effective implementation of increased competition and the reliance on market forces in the public sector, which themselves are directed towards improvements in the nature and quality of outputs and their efficiency. Decisions on contracting out (Australia, New Zealand, UK, US) and on market testing (UK) require assessments based on full resource costs of public sector provision vis à vis the cost of private sector services. User charging, both internal and external, (all countries) depends on comprehensive costing which is a feature of accrual accounting. The creation of internal markets (Australia, New Zealand, UK) requires accrual based costing and accounting arrangements.
- . facilitating more efficient and effective resource management. By enabling assessments of full input costs in relation to outputs, accrual accounting provides a mechanism for quantifying the level of efficiency of programmes and activities and assessing changes in it over time (all countries). It facilitates the creation of additional, more strategic, incentives and efficiency pressures on managers which can take the form of a capital charge (New Zealand) or returns on capital or net assets (UK). Coupled with appropriate flexibility, it can encourage decisions about the appropriate nature and level of asset holdings and better management of them by making the values of underutilised assets visible (Australia, NZ, UK). Accrual accounting can enhance cash management by incorporating details on accounts payable and receivable and inventories which thus minimise working capital requirements (Australia, NZ, UK). It can facilitate additional means of performance assessment via the use of "benchmark comparisons"

between similar entities within the public sector and between similar public and private sector activities (Australia, Iceland, NZ, UK).

- improving accountability by extending the assessment of financial performance beyond the use and application of cash.
- providing a longer term focus on the effects of government or management decisions. Accrual accounting can enhance information concerning the long term sustainability of fiscal policies by bringing to account the future expenditure implication of decisions in the period in which decisions are made. It enables transactions creating future liabilities to spend to be placed on a similar basis to cash transactions and can thus reduce or remove the perceived incentive to meet programme or policy objectives by deferring the costs of activities to future years and/or generations. This is seen as particularly important by some countries (US, Iceland) where the creation of contingent liabilities in the form of loan guarantees and pensions have been a common and significant means of implementing public policy. Some countries (Australia, NZ, US) see benefits from accrual accounting extending to considerations relating to the financial policy and performance for government as a whole. Interest centres (to varying degrees in NZ, Australia, Iceland, US) on the perceived gains from information on the financial condition of the public sector as a whole including assessment of: the public sectors net worth and changes in it over time; intergenerational equity reflected in the aggregate balance between taxation and borrowing; and contributions to current and future well being in terms of the structure of physical, human and research and development capital.

#### **IV. IMPLEMENTATION -- APPROACH, CONDITIONS, AND RISKS**

Introducing accrual accounting arrangements is no guarantee that the potential benefits outlined above will either arise or be realised. Their manifestation will depend importantly upon careful implementation including considerations related to their design and the manner in which they are implemented within the milieu of public sector reform.

##### **Limits to Financial Information**

In all countries there is recognition that more comprehensive accounting and reporting arrangements will not provide all the information necessary to enable assessment of government or management performance. Accruals information needs to enhance, or be enhanced by, information on outputs, quality of service, efficiency, effectiveness, as well as cash if there is to be any synergy resulting from the arrangements. Similarly, the extent of the contingency inherent in some potential liabilities (e.g. some guarantees: pensions, etc.) may preclude their quantification and thus their recognition in financial statements. Supplementary information may be necessary.

##### **High Level Strategy**

A high level implementation strategy is desirable to incorporate the broad interests of all parties within government so as to ensure all the needs of users are addressed. Virtually every country has chosen an implementation strategy which seeks to incorporate the broad interests of all parties to the public sector performance and accountability process in the design of arrangements. To varying degrees this has involved the establishment in countries of high level committees or working parties to develop and oversight implementation of arrangements involving to varying degrees across countries membership or

involvement from Parliament, central management agencies, spending ministries, audit agencies and private sector accounting bodies.

## **Accountability**

The basis of accountability must be clearly (and broadly) defined and managers must be given the incentive, flexibility and information to enable them to make resource allocation decisions consistent with the basis of accountability. If changes are limited to accrual reporting and managers continue to operate and be held accountable on the basis of cash budgets, then accrual accounting risks becoming another form of compliance reporting and its full benefits may not be realised.

All of the countries in this study either envisage, or have put in place, arrangements which involve accrual budgeting or planning on an accruals basis. In some (New Zealand and Iceland) this involves a change in the nature of appropriations to an accrual basis. In New Zealand this seeks to reflect the governments interests as purchaser of outputs from departments at an efficient price. This is supported by statements of projected performance including projected accrual based financial statements. In Iceland, the intention is to have the Budget approved on both a cash and accruals basis reflecting the desire to have ex ante and ex poste reporting on the same basis and to ensure the authority to incur future spending obligations receive prior parliamentary approval. In Australia, New Zealand and the United Kingdom systems have or are being designed which require and encourage managers to use the information derived from accrual accounting systems internally to plan resource allocation and management decisions on an accrual basis, and which yield day to day information which supports effective decision-making.

## **Capacity, Skills and Culture**

The introduction of accrual accounting implies a requirement for substantial investment in management information systems in order to support ex ante budgeting requirements and to support improved management practices. It requires a cultural change by managers within departments and agencies through an understanding and acceptance of how to use the additional information and of the potential benefits which it provides, and a commitment to change. This in turn requires an investment within individual departments and agencies in re-skilling either through recruitment or training, and by central management agencies in disseminating best practice.

These issues have or are being explicitly addressed in countries. For example in the United States, the Chief Financial Officers Act explicitly makes the CFO for each agency responsible for developing and implementing strategies to obtain high quality financial management personnel. CFO's are also required to develop and maintain integrated agency accounting and financial management systems to support reform. Proposals in Australia recognise the importance of the Department of Finance's role in leading the process through advice, assistance and dissemination of best practice. With the progressive commercialisation of elements of the public sector over a number of years (and experience with accrual accounting), there is perceived to be a growing level of expertise within government which can be shared.

Similar approaches are evident in the United Kingdom. Agencies may not be established unless the prospective body can satisfy the parent department and the Treasury that it has, or will soon be able to develop, the necessary management information and accounting systems to operate satisfactorily and to enable the parent department and the Treasury to limit control to essentially strategic matters. Similarly in New Zealand, departments were required to demonstrate, in advance, that they had financial management systems which were capable of providing timely and materially accurate financial information on an accrual basis.

The process of awareness raising and education is also of importance for external users. If Parliament, auditing agencies or the public do not understand or use the accrual information, there will be no added accountability and no new lines of enquiry and pressure to improve performance.

## **Costs and Benefits**

The process of moving along the accounting and reporting spectrum from cash to accrual arrangements involves increasing degrees of sophistication of accounting systems and thus increasing costs. These need to be balanced by consideration of perceived benefits. Clearly the total benefits to all users that are expected to arise from providing information should exceed the costs of providing it. Costs include the costs of recording, summarising reporting and auditing the information. Benefits and costs may accrue to different parties and the evaluation of the nature and amount of benefits and costs will necessarily be judgemental. Benefits are also likely to accrue over a longer time period compared to costs which will be greatest when systems are first established. The nature and extent of accrual arrangements introduced should desirably be informed by these judgements.

Countries have addressed these issues to varying degrees. Arrangements being introduced in the United States under the umbrella of the CFO Act explicitly require OMB to report on the costs and benefits associated with preparation of financial statements. Each agency CFO is required to establish systems for tracking and recording all costs incurred in the preparation of financial statements and to identify the benefits from their preparation with quantification in dollar terms to the extent possible. In the United Kingdom arrangements introduced for supply (appropriation) financed agencies seek to tailor arrangements to the nature of Agency business and the frequency and speed of management information required. It is recognised that at one extreme an Agency may require new and sophisticated systems; while at the other periodic adjustments to cash based accounts may be adequate. An important element in the proposed piloting of Departmental Resource Accounts in the United Kingdom is the identification of costs involved in producing these accounts on a regular and systematic basis.

In most countries however it is implicitly acknowledged that the full assessment of costs and benefits must await experience with implementation. Underpinning this view however is a perception that the incremental nature of public sector reforms introduced in recent years, which in many instances have been required to be supported by progressively more comprehensive financial information, has resulted in much of the upfront costs associated with the introduction of accrual accounting having been met. Thus the marginal benefit from the introduction of more systematic and integrated accrual accounting systems is seen to be high. In Australia, for example, the increased focus on performance has seen significant growth in departmental management information systems many of which have been based on commercially available software packages which include accruals capacities.

## **Reporting Model**

There are many different ways accrual based financial information can be reported in financial statements ranging from simple lists of assets, liabilities revenues and expenditures to articulated (integrated) financial statements that show a financial position, changes in that position, operating results and cash flows. The precise reporting model chosen is not fixed; decisions should reflect a balance between the objectives set for financial reporting and costs. Yet, how financial information is presented places emphasis on different messages and can determine the extent to which user needs are met.

All countries in this Study have chosen a model involving the preparation of articulated financial statements, similar to the format applying to private sector entities. This reflects judgements about the net qualitative benefits which this model is perceived to offer (reliability, consistency, understandability, etc.)

and the wider accountability and decision-making potential which can result. Most countries require the preparation of at least the following statements:

- . an operating statement reflecting revenues and expenses and showing net operating position;
- . a statement of assets and liabilities summarising the assets and liabilities of the entity;
- . a cash flow statement showing the flow of cash in relation to operating investing and financing activities;
- . notes or schedules which clarify or show additional information on a disaggregated basis for users seeking more details.

While the reporting model adopted is similar to the private sector no country has sought blind adherence to private sector practices. There is common agreement that an important condition for the usefulness of this format is that it be adapted to recognise the important differences between the nature of public and private sector activities, their objectives and their financing. Operating Statements (as opposed to Profit and Loss statements) have been developed which focus on the gross and net cost of services. Their design aims to enhance the ability to assess performance by showing the full cost of resources consumed in programme delivery; identifying the extent to which costs are recovered through charges; and the net cost of program delivery. These statements may facilitate value for money and efficiency assessments by enabling an appreciation of the relationship of outputs to the full cost of resources consumed. As they reflect ongoing cost flowing from past decisions (e.g. depreciation), they provide incentives to management to reassess those decisions.

Similarly the Statement of Assets and Liabilities is distinguished from the private sector Balance Sheet in their design and intent. In recognition that solvency for departments is determined by continuation of appropriations the main focus of the information produced for these Statements is directed toward assessing an entities control over resources; funds necessary to enable the entity to meet its long terms obligations; and capacity for adaptation through restructuring or redeployment of assets. Net worth and changes in it over time may provide an additional indicator of performance.

## **Accounting Policies**

Another important consideration to be addressed in designing accrual accounting arrangements for the public sector concerns developing specific accounting policies and standards. Private sector experience and practice has provided useful insights to assist in addressing this issue, and these have been embodied to varying degrees both in the accounting policies applied in all countries, and in the consultation processes established between the public and private sectors in the setting and promulgation of new or modified standards (Australia, UK, NZ).

It is clear from country experiences to date, however, that private sector norms cannot be expected fully to address the public sector environment. There will always be a need to develop new accounting policies specific to elements of the public sector, notwithstanding the perceived advantages of harmonising financial reporting between the public and private sectors. Two issues which have been common to such considerations in virtually all countries concern the appropriateness of valuation and treatment of public assets and liabilities using the traditional private sector concept of historic cost; and, the perceived technical difficulty and, in some cases relevance, of valuing certain assets and liabilities for which there is no private sector equivalent e.g. infrastructure and heritage assets, sovereign taxation powers, pension and superannuation liabilities.

On historic cost, the periodic revaluation of assets to take account of changing prices has been recognised as crucial to the ability to use accrual based information to set performance targets in the public sector and to assess whether they have been achieved. Strategic targets (usually set in real terms) of returns on capital or net assets, as well information on (accrued) costs which are fed into considerations of efficiency, setting charges, market testing etc. lose utility if the consumption of these resources is not reflected at current value. Historic cost in the context of the public sector introduces a downward bias on costs which in turn can produce false notions of efficiency. Most countries have therefore adapted their accounting policies to incorporate requirements for periodic revaluation of assets.

The limits in applying accrual accounting to the public sector as a result of perceived difficulties in valuing certain categories of assets, appears still to be a concern. These are, however, mainly confined to reporting at the whole of government level. The accounting policies countries have applied involve the recognition (and capitalisation) of transactions in Statements of Assets and Liabilities on the basis that agencies have control, or derive the economic benefit or service potential, from the particular asset or liability. This contrasts with those transactions which are administered on behalf of other entities, or the government as a whole (e.g. administering pensions and benefit payments; and effecting tax collections). Where the reporting entity constitutes a programme, agency or department, the transactions giving rise to these "difficult to value" assets and liabilities are in the nature of administered ones and the financial statements of these entities need not address questions of valuation of these elements. Thus, this issue does not seem to pose an impediment for accrual accounting achieving its full potential at this level.

### **Whole of Government Reporting**

When the reporting entity is the government as a whole, such distinctions do not apply -- the government controls or receives the service potential or economic benefits from these transactions which implies they should be reflected in financial statements prepared at this level, to the extent that such reporting is considered appropriate.

In terms of country practice, only one country, New Zealand, has implemented arrangements for the comprehensive reporting at whole of government level and has reached a position with respect to these assets and liabilities. Iceland has reported on a whole of government basis but financial statements are confined to reporting financial assets and liabilities. Extension to incorporate the reporting of physical assets and liabilities is under consideration. The United States is exploring this issue in the context of its developments. Work so far in Australia has suggested benefits in establishing an integrated financial framework to enable reporting on a whole of government basis, including comprehensive reporting of assets and liabilities at the whole of government level. In the United Kingdom there are no intentions at this stage to report on this basis.

The New Zealand approach is useful in providing insights into how governments might address at least some of the perceived valuation problems at the whole of government level. Valuation of government assets and liabilities has been based on determining a financial value alone; not an intrinsic or social one. For example, National Parks and conservation areas have been valued on the basis of land values in the same general location; state highways are valued on a depreciated replacement cost basis taking account of costs of new construction with assumptions of an indefinite life for the road formation structure; national archives values reflect a best estimate of net current value based on a sample of recent sales or, if no sales have occurred, an assessment of relative value compared to other categories.

The future payment of non contributory welfare benefits has not been included in the consolidated financial statements for New Zealand on the basis that they are financed from general taxation and paid for at the discretion of the government; it is difficult to predict such future dispositions and it has been considered that their inclusion would not meet the test of reliability. Similar concerns with the reliability of estimates of future taxation receipts have resulted in their exclusion. Exclusion has also been argued

on the basis that users are interested in information on financial position before consideration is given to taxation powers.

Apart from questions of valuation, whether and how accrual based information should be consolidated to produce financial statements for the Government as a whole remains a matter of continuing consideration for most countries.

The major interest in aggregate government budgeting and reporting continues to be its macroeconomic impact. In this respect the amount of cash raised and expended is the best indicator of the impact of the public sector on the economy; and the cash surplus or deficit best describes the relationship between fiscal and monetary policy. There is no suggestion or consideration being given to dispensing with this form of reporting.

A number of conceptual and practical concerns for accrual based reporting on a whole of government basis have been identified<sup>3</sup>. These include, among others, defining the reporting entity; establishing whether elements of financial statements at whole of government level should be expressed in terms of statistical and economic data (e.g. on a per capita basis or as a percentage of GDP) to facilitate comparison between governments and countries; whether whole of government balance sheets should be limited to reporting financial assets and liabilities; identifying transactions and balances between entities to permit consolidation; establishing reporting formats which facilitate use by the general public. The utility of a figure for government net worth, and changes in it, is also the subject of consideration. While beneficial as an indicator of the impact of current fiscal policy on intergenerational equity and fiscal sustainability, its practical value may be limited unless such information is actually used in making and evaluating resource allocation decisions.

Although these issues remain to be resolved by some, the approaches being adopted or considered in other countries suggest they may not be insurmountable. Even if such concerns cannot be resolved to the satisfaction of countries, they should not preclude benefits being achieved from the introduction of accrual accounting arrangements at the programme, agency or departmental level.

## **V. CONCLUSIONS**

For most countries in this study accrual accounting arrangements have not yet been fully implemented; they are largely at the conception and/or design stage. In the one country that has fully implemented arrangements (New Zealand) experience is limited to around two years. As for most public sector reforms introduced in recent years, the full extent to which accrual accounting has or will actually benefit public sector management and the accountability process will need to be assessed over the long term. At this stage therefore the conclusions of this study are necessarily limited to observations on expectations and perceptions, on the basis of limited experience to date. Given this qualification, the following conclusions are offered.

Accounting and financial reporting systems are an important tool by which public sector managers, governments and external users can obtain information useful for decision-making and discharging accountability. However, rather than representing two mutually exclusive options, full cash and full accrual accounting should properly be viewed as end points on a spectrum of possible accounting and reporting bases. Within these boundaries there are numerous adaptations, or degrees of application, which can be effected to modify accounting systems in order optimally to meet these primary objectives.

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3. Barrett P.J. -- "Managing in an Accrual Environment". Paper presented to a Conference of the Royal Australian Institute of Public Administration, 26 February 1993.

Recent efforts to apply accrual accounting to the public sector are not undertaken for their own sake, on the basis of a belief in the superiority of this form of accounting. Rather they aim to arrive at the best mix of cash and accrual based financial information for use as an additional management tool to stimulate and reflect better, more results oriented, public sector performance. Accrual accounting thus needs to be viewed as a means rather than an end.

Depending on the characteristics, nature and objectives of public sector entities, the objectives for financial reporting are seen to encompass information requirements useful to assess stewardship of resources and compliance with legal requirements; state of finances; performance in terms of economy, efficiency and results; and economic impact. The accounting bases underlying accounting and financial reporting systems have important implications for the nature of information they provide and thus the extent to which these objectives and related information requirements can be met.

The value of cash accounting in assessing the macro-economic impact of public sector activity and in informing judgements about the relationship between fiscal and monetary policy is unquestioned. This, of course, is not to say that cash information alone is all that is necessary for fiscal and monetary policy considerations. Nor does it imply that macroeconomic policy may not be better informed with accrual based financial information. Fiscal policy, for instance, might benefit from accruals data where issues of long term fiscal sustainability and/or intergenerational equity are a concern.

The additional benefits which accrual accounting can provide for public sector entities include 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.

To the extent that the nature of accountability within the public sector shifts from a relatively narrow focus on compliance with spending limits, to encompass accountability for the outputs, efficiency and results of activities; to encompass concerns with total resource management reflected in full costs of operations; or to reflect longer term obligations and overall financial condition; some form of accrual accounting is necessary to reflect and provide the information necessary to support decision-making in these terms.

While financial information provided under accrual accounting arrangements is a necessary condition to enhance decision-making and accountability for results, it is not a sufficient condition. Achievement of benefits will depend on a number of conditions:

- Accrual based financial information needs to be enhanced by data on outputs and quality of service, and be fed into assessments of efficiency and effectiveness, to provide robust indicators of public sector performance.
- An implementation strategy needs to be devised which incorporates the broad interests of all parties to ensure the needs of all users are reflected in the arrangements;
- The basis of accountability needs to be clearly defined and managers must be given the incentive, flexibility and information to enable them to make resource allocation decisions consistent with accrual based information.
- Arrangements need to be supported by investment in management information systems, skills and in changing the culture of management, to enable and encourage the use of accrual based information for day to day decision-making.

- Arrangements should reflect the outcome of an assessment of costs and benefits; depending on countries' assessments, using elements of accrual accounting, or applying it judiciously to specific activities might be regarded as more cost-effective than full introduction.
- Arrangements cannot necessarily be translated directly from the private sector; countries need to invest where necessary in developing accounting policies and reporting arrangements which appropriately reflect the specificity of particular public sector activities.

Satisfactory resolution of perceived difficulties with whole of government reporting on an accrual basis is not an impediment to benefits being achieved from its implementation at the programme, agency or departmental level. And it may be that accrual accounting is considered more useful in certain activities than in others e.g. in contemplating contracting out, market testing or in activities where significant capital assets are involved. Notwithstanding this, experience with whole of government reporting in one country suggests perceived difficulties on this score may not be insurmountable.

The perceived benefits of reporting on an aggregate basis for the government as a whole are of a different type than the value for money considerations underlying reporting at the programme, agency or departmental level. They encompass concerns to enhance information and decisionmaking on long term fiscal sustainability and in assessing intergenerational impacts of government policies. The extent to which these potential benefits are achieved will only be known in time when a history of measures is established and when judgements can be made on the extent to which such information has actually impacted upon resource allocation decisions. In those countries which have implemented or are proposing to implement such arrangements, the hopes are high.



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## **PART II COUNTRY EXPERIENCES**



# AUSTRALIA

## ACCOUNTING AND REPORTING BACKGROUND

### **General Government**

Public sector reporting in State and Federal jurisdictions in Australia incorporates varying degrees of cash, modified cash and accrual accounting. Government departments generally report on a cash basis which reflects the basis on which respective Parliaments appropriate funds. A number of jurisdictions require modified cash based financial statements incorporating information on both cash receipts and payments as well as supplementary information concerning assets, liabilities and financial commitments. Departments in the State of New South Wales are progressively moving to accrual based financial reporting. The State of Victoria have initiated a pilot study involving six departments that will trial accrual based financial reporting.

Most Public Enterprises, financial institutions and commercial undertakings both Federally and in the States are required to report on an accrual basis. This reflects the generally common agreement among all governments that financial reporting of assets, liabilities, revenues and expenses is essential to facilitate decision making on efficient resource allocation, assist performance measurement and discharge accountability for these bodies.

Non-commercial public activities prepare accrual based financial statements in some jurisdictions and cash in others. They are subject to (cash) funding controls similar to departments.

### **Central Government**

Traditionally, departments and public authorities at the Federal level have been required to account on a cash basis for the receipt and payment of public moneys against budgeted amounts for each statutory fund. This approach is known as *fund accounting* and the reporting of information in this way referred to as *compliance reporting*. One obvious limitation was that this approach treated current expenditure (consumed within the year) and capital expenditure (partially consumed within the year and still available for future years) in an identical fashion.

At the Federal level it was recognised at an early stage that this kind of reporting was insufficient for measuring the performance of commercial activities and the Postmaster-General's Department moved to accrual based reporting in 1913. Since 1983, budget funded statutory authorities have been required to prepare accounts on an accrual basis, having regard to Australian Accounting Standards. Departmental business undertakings are expected to operate on the same basis. The guidelines for financial statements issued by the Minister for Finance in these respects are modelled on the Companies Regulations.

On 4 November 1992 the Australian Minister for Finance announced that Federal Government departments would move to financial reporting on an accrual basis as the next step in the Governments public sector reform program. The remainder of this note focuses on these developments. It outlines the rationale for this change including the public management context and developments that have been relevant. It also describes the nature of the proposed arrangements, how they will operate and developments to date.

## PUBLIC MANAGEMENT REFORM

In the 1980s, traditional views on management and accountability were increasingly questioned. Parliament voiced the opinion that its scrutiny should extend beyond ensuring compliance with spending limits to cover the *efficiency* and *effectiveness* of public expenditure. The Parliamentary Public Accounts Committee saw the financial system extending beyond fiscal compliance to deal with *viability* and *efficiency*. It said (1982) that the cash based system of accounting is not in itself an indicator of future viability, but immediate viability. It recognised that cash and accrual accounting in the public sector are not mutually exclusive and pointed out that the characteristics of each method can be combined to satisfy different user requirements.

In response to changing circumstances and expectations the Federal Government introduced a series of public management reforms through the 1980's. The primary focus of Federal public sector reforms has been to improve the efficiency and effectiveness of the public sector and its accountability to government and the Parliament. Improved approaches to resource allocation and management have been a priority. The strategies adopted to achieve this have been to:

- foster changes to the budgetary and regulatory environment which will lead (have led) to:
  - . improved resource allocation through more orderly and systematic budgetary processes, including increased devolution to and flexibility for managers in the resource allocation process; and
  - . improved programme effectiveness and programme management, generally by encouraging a greater focus on results or performance rather than predominantly on processes.
- promote high quality standards, practices, skills and training in resource management in departments to improve efficiency in the use of resources.

In essence the goal has been to create an environment which encourages better management; encourages a more systematic approach to management; and introduces and develops the techniques which support results management. The intention has been to focus managers' sights primarily on the objectives of government programmes and give them the scope and flexibility to manage resources directed to the achievement of those objectives.

The environment which has been created, with its focus on programme performance, has demanded better information to allow the effectiveness of programmes to be assessed, and resources to be allocated and managed more efficiently. More comprehensive information on revenues and expenses, and assets and liabilities is a subset of such information.

Comprehensive financial information has been required for decisions concerned with, for example: the evaluation of programmes and proposals; determining prices for goods and services; lease/buy alternatives; benchmarking and outsourcing.

In a number of key areas the Government has taken decisions to require (and encourage) managers to pursue cost-effective options consistent with the value-for-money objectives inherent in the reforms. For instance, for Commonwealth departments, the production of goods and services may only be undertaken in house where it can be justified having regard to the full cost of in-house production. This requires that departments take into account all economic costs, including superannuation and depreciation, in their assessment. In a similar vein, departments are required to test the market for the outsourcing of both new and existing information technology requirements as an alternative to the maintenance of in-house capabilities. The intention is that this be done with a view to achieving maximum outsourcing, subject to value for money, efficiency and public policy considerations.

## ACCRUAL ACCOUNTING

### **Developments through the 1980's**

Developments in public sector accounting have been influenced by the overall reform environment. The changes in respect of devolution, the focus on results and the need for improved accountability all implied the need for enhanced financial reporting. Accounting reforms at the Federal level therefore reflected an emphasis towards requiring the provision of information that would encourage more effective management, while at the same time recognising that this approach would provide greater accountability.

As far as financial reporting by departments is concerned accounting arrangements through the 1980's continued to develop in response to the needs of government public sector managers, Parliament and other users. Increasingly through the decade new needs for modified forms of financial reporting developed in response to the changing public management environment with its results orientation and value for money focus. The Federal Government moved progressively toward a modified cash (modified accrual) system for mainstream departmental activities. Departments were required to disclose:

- . the cash receipts and expenditure of the Consolidated Revenue Fund, Trust Fund and Loan Fund against Budget estimates/appropriations;
- . cash receipts and expenditure presented on a programme basis; and
- . supplementary information on certain assets and liabilities including cash holdings, investments, debtors, creditors and non-current assets (excluding infrastructure assets and for the time being, most land and buildings).

### **Recent Developments**

These progressive changes to reporting requirements received added impetus from two recent parallel developments. The establishment and subsequent report in May 1992 of a joint Federal/State working party to consider issues associated with public sector accounting, reporting and budgeting was an important stimulus to further change. The working party was a response on the part of all governments to a desire both to enhance and to harmonise financial reporting across jurisdictions.

It concluded that while cash had traditionally been the basis of government accounting, its extension to include information on assets, liabilities, revenues and expenses would contribute towards better overall resource management. In particular it would focus attention on the full costs and revenues of programmes and government operations to aid decision-making and to enhance both internal and external accountability. Accrual accounting was seen as only one of a range of measures which would contribute to improving the efficiency, effectiveness and accountability of the public sector. The Working Party considered that the objectives of reforms in government accounting should focus on the need for producing relevant and reliable cash and accrual information as a base on which to develop and encourage sound financial and resource management practices in the public sector. The debate should not be about cash or accruals but about the characteristics of systems which generate information necessary to enhance decision-making and discharge accountability. Accordingly the Working party recommended that:

- governments examine the decisions that managers and users of financial statements need to make about departments and authorities that operate on cash accounting systems and, where information derived from accrual systems would assist in the management of resources,

assessment of performance and financial position, and the discharge of accountability, pursue the introduction of such systems; and financial statements;

- financial statements that are prepared on an accrual basis should be prepared in accordance with Australian Accounting Standards and Statements of Accounting Concepts.

The other (reinforcing) issue affecting developments was the release of an exposure draft on "Financial Reporting by Government Departments" by the Australian Accounting Research Federation, a body jointly established by the Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants in Australia to, amongst other things, improve the quality of financial reporting and auditing in Australia. It too recommended that departments prepare financial reports in accordance with Statements of Accounting Concepts and Australian Accounting Standards -- in effect requiring accrual based reporting.

### **Current Proposals**

Against this background the Department of Finance initiated a pilot study in 1992 to assess the value of these proposals. This involved the preparation of supplementary financial statements for the Department of Finance along accrual lines. These statements, together with their underlying structure and accounting policies, are to provide the basis for the extension of accrual reporting to all government departments. The supplementary (and proposed department-wide) financial statements (will) comprise:

- . an operating statement;
- . a statement of assets and liabilities;
- . a programme statement;
- . a statement of cash flows; and
- . notes.

The statements focus on the full cost of providing departmental services and also require departments to report comprehensive information on assets and liabilities. The statements are linked to each other (e.g. the cost of assets affects both the statement of assets and liabilities, and the operating statement in the form of depreciation expense; expenditure on employee benefits (superannuation) charged to the operating statement also affects the value in the statement of assets and liabilities to the extent they create a liability).

### **Accounting Policies**

Consistent with recommendations of the two review bodies, the Statements are based on Australian Accounting Standards and Concepts Statements which are comparable to accounting standards applied under Australian Corporations Law (the standards are basically the same). Of particular significance here are the definitions developed for the different elements of the financial statements (assets, liabilities, revenues and expenses) to reflect the nature of public sector activities; and the consequence of these for the manner in which they are reported. A key distinction has been drawn between the elements of the financial statements which departments control and those which they administer on behalf of the government as a whole. These two components are reported separately. Thus, for example, the Department of Finance administers loans from the Federal Government to State Governments and other bodies. Although the department collects the repayment, it must pass them onto the government and does not therefore have control of them for its own purposes. Assets in the financial statements are thus split between those controlled by the department and those administered for the government as a whole. Similarly public debt is an administered liability and is reported separately because securities are issued on behalf of the Government. Likewise taxation, customs duties and fines are revenues of the government not the department administering them, and

unemployment benefits and pensions expenses of the government rather than the departments administering them; and would be reported separately in relevant departments' financial statements. The underlying point here is that if the statements are to be of use for decision-making and accountability purposes they must clearly distinguish between those elements over which departments have influence and responsibility and those for which they do not.

## **Benefits**

The broader application of accrual accounting arrangements is seen to provide a range of differing benefits to users.

Potential gains for *external users* are seen to include:

- . greater accountability of management (and government) for their performance (this could act as a spur to better performance);
- . ability to assess the full cost of resources consumed by programmes;
- . matching the timing of activities and their financial effects (to enable assessments of financial performance);
- . providing a basis for assessing changes in efficiency (e.g. for comparing operating costs between years; comparing with other departments; comparing with physical outcomes and linking with statistical information);
- . providing information about resources controlled and obligations incurred (e.g. for facilitating assessments of the potential for redeployment of assets and the level of resources required to meet obligations); and
- . providing a longer term focus on the financial effects of management (and government) decisions.

For *management*, the systems needed to produce such financial statements could provide a wider range of information needed for day to day decision making and enable more effective use to be made of a given level of resources. In particular the information would provide a more effective basis for decisions about such matters as:

- . pricing of goods and services for the recovery of costs (user charging);
- . cost control (e.g. previously "hidden" or unidentified costs of past decisions would be visible and able to be reassessed);
- . effective deployment of assets (e.g. by making the values of under utilised assets visible, management are more likely to redeploy or dispose of those assets);
- . co-ordination of activities to minimise working capital requirements (e.g. to control the amount of cash tied up in receivables and inventories);
- . identifying savings options to finance high priority objectives;
- . enabling better assessment of the costs of new policy proposals against original estimates;

- . evaluating contracting out and leasing options; and
- . workplace pay bargaining.

In terms of the statements themselves, the operating statement is intended to focus on the gross and net cost of Services rather than the bottom line (i.e. profit and loss), emphasising the difference between the activities of a government department and those of a commercial entity. Information in the Operating Statement is seen to enhance the ability to assess departmental performance by showing the full cost of resources consumed in programme delivery (including the composition of those costs); the extent to which those costs are recovered through user charges and other independent sources; and, the net cost of programme delivery. It can also show the extent to which government funding is covering those costs. Value for money assessments may be made by relating outputs and outcomes to the cost of resources consumed in their achievement (input costs) and changes in performance may be assessed by comparison with amounts for previous years. Since the statements include ongoing costs that stem from past decisions, they are likely to provide the incentive for management to re-assess those decisions.

The Program Statement disaggregates information in the operating statement and statement of assets and liabilities for each programme. This form of presentation is seen to lend itself to assessment of the department's administrative efficiency, as well as showing the level of resources managed on behalf of the government as a whole.

The Statement of Assets and Liabilities is distinguished from the private sector balance sheet which is used to assess solvency. In recognition that solvency for departments is determined by continuation of appropriations, this statement's main attribute is to enable assessment of the department's control over resources, the level of funds that will need to be provided to the department to enable it to meet its obligations, and its capacity for adaptation (e.g. restructuring and redeployment of assets). Also, assessment of factors such as the turnover of inventories and the ageing of receivables could highlight the inefficient use of funds and provide incentives to management to reassess asset management practices.

The Statement of Cash Flows shows the sources of cash inflows and how cash was applied during the financial year and will highlight the corporate role of management in co-ordinating and managing the department's cash resources.

## **Future Directions**

The intention is that departments should move to financial reporting on an accrual basis over the ensuing 2-year period with current expectations that all departments would report on an accrual basis for the financial year ending 30 June 1995.

Notwithstanding views expressed by the Federal/State Working Party as to the benefits of accrual budgeting (including, the desirability of having benchmarks by which to assess results against expectations; to assist strategic planning and management) an assessment still has to be made at the Federal level as to the benefits of budgeting on an accrual basis. In any event, the introduction of accrual budgeting would be intended as an adjunct to cash budgeting not a replacement of it in view of the importance of the cash budget as an economic document; planning on an accrual basis at the programme or departmental level is however seen as crucial to the effectiveness of the arrangements.

Work is also being undertaken to assess the value and feasibility of whole of government reporting on an accrual basis. While work thus far indicates there are net benefits from establishing an integrated financial framework and reporting on whole of government, a number of conceptual issues have been identified for resolution. These include:

- . How to define the reporting entity? For example whether there should be one consolidation or should there be separate consolidations of the budget sector and the non-budget sector or the general government sector and the public trading enterprises sector.
- . Having regard to the diverse activities of government, including commercial activities, non-commercial activities, banking and the redistribution of wealth, the meaning of the operating result for the government as a whole is not immediately evident.
- . In addition to valuation and recognition problems associated with departmental reporting there are perceived problems in reporting on what are sometimes referred to as Crown revenues, expenses, assets and liabilities (e.g. transfer payments, taxes, fees, and fines, public debt); in particular how pension liabilities are determined; whether securities on issue should be valued at face value or at their discounted present value; whether income taxes should be brought to account when they are paid, when they are assessed or when income is earned by taxpayers.
- . Contentious issues remain concerning how to value public sector assets such as infrastructure and heritage assets.

## **CONCLUSION**

The reform measures introduced Federally in Australia have been directed toward improving the efficiency and effectiveness of the public sector and its accountability to government and Parliament. The reforms to financial reporting already implemented and those proposed are consistent with and a necessary part of the broader emphasis on improving public sector performance. The nature and quality of financial reporting by commercially oriented areas of the public sector and Government Business Enterprises is considered to be of a high standard. Work underway to apply similar accrual standards to departmental reporting practices will further enhance resource management and accountability for these elements of the public sector.



# ICELAND

## ACCOUNTING & REPORTING BACKGROUND

Iceland's Budget and Accounting Act of 1966 prescribes that all **budget sector** agencies should budget on a cash-basis and prepare ex-poste financial statements on an accrual-basis. The concept of accrual reporting was therefore introduced into the government's financial reporting system over a quarter of a century ago. The actual application of accrual accounting standards was, however, lacking until reforms were made to reporting for the 1989 Financial Statements which were published in 1991. Up to this time Agency operations were on a full accrual basis except for unfunded pension obligations, cost sharing projects, interest expenditure and Treasury guarantees.

**Non-budget sector** entities comprise activities of a commercial nature. These entities budget and report on an accrual basis. Indeed many have their activities audited by private sector accounting and auditing firms. Agencies within this category are free to use discretion in day-to-day management, with Government intervention limited to the setting, where appropriate, of strategic controls over financial performance and borrowing. These entities are required to adhere to generally accepted accounting practice as recognised by the accounting profession in Iceland including, inter alia, the preparation of Operating Statements and Balance Sheets.

A significant number of public enterprises, both financial and non-financial, have either not been accounted for or not systematically reported under existing arrangements. It was believed imperative that the financial reporting system encompass all government entities. The Minister for Finance accordingly directed the Financial Reporting Commission in 1990 to institute a comprehensive review of the government's financial reporting system and make recommendations for changes to the Budget and Accounting Act of 1966. The Financial Reporting Commission is a statutory body created by the Budget and Accounting Act. Its purpose is "...[To] advise the Minister of Finance on the structure of the Budget, the Financial Statements and all related matters..." The Commission has six ex-officio members representing the Ministry of Finance, the State Accounting Office, the State Audit Office, the Bureau of Statistics, the National Economic Institute and the Central Bank of Iceland.

One of the initial tasks of the Commission was to recommend public sector reporting be more comprehensive. A new classification system is planned grouping each government entity within one of five sectors depending on the nature and function of the agency:

**Group A.** The "General Fund" comprises all budget sector agencies, i.e. all ministries and subsidiary agencies; the Parliament and its subsidiary agencies; the Supreme Court and the District Courts.

**Group B.** Nonfinancial public enterprises wholly owned by the Government. These do not include corporate enterprises. Government intervention of the operation of these enterprises is largely based on approving of their tariffs, investment levels and borrowing activity. The largest enterprises within this category are the Post and Telecommunications Administration and the Electric Power Works.

**Group C.** Consists of Government Lending Institutions which are engaged in both incurring liabilities and acquiring assets in the market. These institutions usually issue bonds domestically or abroad and the proceeds are relent mainly to individuals and industries. Most of the Government Lending Institutions are Investment Credit Funds which channel long term capital to individuals in the housing sector and private enterprises for investment purposes. These funds, which are not deposit-taking institutions, have a long history in Iceland. Government control rests

largely with nomination of their board as well as capping their annual foreign borrowing authority in a Credit Budget.

**Group D.** All enterprises incorporated as limited liability companies are included in this group.

**Group E.** The two state-owned commercial banks are classified in Group E as well as some other state-owned deposit-taking institutions. The Central Bank is also classified in this group for reporting purposes. Entities in Group E are independent of direct government control.

As part of its deliberations the Commission recommended that all on-budget agencies should report and budget on a full accrual basis. This conclusion was primarily influenced by Parliament's desire to have all government entities accountable to it.

## **PUBLIC SECTOR REFORM**

Economic conditions have largely influenced public sector developments in Iceland in recent years. The primary objectives of the Government has been the elimination of the budget deficit through reductions in expenditure. As a result there has been much pressure on the public sector to use available resources more effectively and efficiently to maintain and improve service standards. A series of management reforms have been instituted in support of this. These have had implications for public sector accounting and reporting developments. Reforms have generally been directed toward devolution of responsibility and accountability as far as possible to give managers maximum freedom in running their operations within a framework of tight aggregate spending controls.

A **decentralised budgeting system** has been adopted based on negotiated budget caps for each Ministry's spending; most agencies now have their appropriations as a single line item; the reliance on **user fees** has been increased significantly as a replacement for tax increases. The costings that serve as the basis for applying fees is being refined to reflect full accrued costs and application of fees across ministries is being harmonised.

**Unit cost analysis** across a number of homogeneous agencies has recently been introduced. Unit costs (which will progressively be enhanced to reflect full accrued costs) within each group are compared to assess relative efficiency and demonstrate relative trends. The objective is to introduce yardstick competition by demanding that every agency rise to the level of best practice within its group.

A comprehensive programme of **privatisation** of partly-owned non financial enterprises has begun. A number of limited liability companies in the cement, fertiliser, herring and pharmaceutical industries have been identified as candidates. As these bodies already account and report along private sector (accruals) lines establishing their performance in commercial terms is facilitated.

The government subsequently introduced **credit reforms** embracing elements of accrual budgeting. These involve an annual appropriation being made equal to the present value of the subsidies inherent in loans and loan guarantees programmes and requiring the lending policies of the institutions concerned be constrained within the limit of the appropriations received each year.

## **ACCRUAL ACCOUNTING**

Although accrual reporting was in principle provided for within relevant legislation, its actual application did not occur until the late 1980s. The main reason underlying the Financial Reporting Commission's recommendations for the fuller application of accrual accounting practices appears to have been to identify the magnitude, enhance control of, and improve decision-making on longer term

liabilities by both government and the Parliament. There was concern that traditional cash budgeting and (modified) cash reporting was not providing sufficient information on the nature and extent of longer term commitments. There was a belief that governments had in the past resorted to "off-budget financing" through loans, guarantees and other commitments to finance activities that would otherwise have had to be funded through the cash budget. Recent experience with the "failure" of a number of off-budget bodies reinforced this concern. A number had defaulted leaving the government to meet the cost. The cash budgeting and reporting system had provided no insights into either the extent of the likely liabilities or the potential for them to arise. These occurrences highlighted, in the absence of alternative information, the potential for a serious erosion in the government's ability to effect long term reduction's in expenditure and the deficit.

Running parallel to these concerns, management reforms have stimulated the demand for accruals type information. The increasing reliance and the setting of user fees implied the need for fuller information and integration of non cash costs when setting fees. Similarly the introduction of unit cost analysis across like agencies and associated judgements about relative efficiency need to extend considerations beyond cash costs alone. Thus reform which was initiated and driven by the desire to improve accountability, decision-making and control over longer term liabilities has received added impetus from more recent developments aimed at improving the efficiency and effectiveness of public sector activities.

In moving to implement revised arrangements, the first step in the reform process implemented by the Financial Reporting Commission was to give effect to the intent of the 1966 Budget Act to shift financial reporting more fully to an accruals basis. The changes implemented to give effect to this revolved largely around the treatment of pension obligations, cost-sharing projects with municipalities, interest on Treasury debt and Treasury guarantees.

### **Unfunded Pension Obligations**

The unfunded pension obligations of the Treasury represent, by far, the largest share of obligations that had previously not been reported in the Financial Statements. The pension programme was seriously underfunded with estimated liability totalling 46 billion Kroner representing around 60 per cent of annual Treasury Revenues. The reporting for these obligations was changed to an accrual basis. An actuarial estimate was made for each pension scheme and all estimated unfunded obligations were reported as accrued expenditures in the 1989 Financial Statements. An actuarial estimate will be carried out yearly from now on with the figures adjusted accordingly.

### **Cost-Sharing Projects**

The Treasury is involved in many joint projects with municipalities and non-profit institutions that are financed on a cost-sharing basis. The financial reporting for all cost-sharing projects was changed to an accrual basis effective with the 1989 Financial Statements.

### **Interest Expenditure**

Accounting for interest expenditure was changed to an accrual basis instead of being reported when actual cash outlays were made. The appropriate definition of interest expenditure is, however, still under discussion. In Iceland, long-term Treasury Bonds are indexed to the Consumer Price Index. The interest rate shown therefore represents a real rate of interest. In the Financial Statements, currently only the real rate of interest is recognised as an expenditure with the indexed component being reported "below the line." Short-term Treasury Bills and Treasury Notes are, however, non-indexed with both the real rate

of interest and the expected rate of inflation reported "above the line." This inconsistency is recognised as needing correction. There is a strong view within the Financial Reporting Commission that only the real rate of interest should be reported "above the line," but there are serious technical difficulties in uniformly applying this standard.

## **Treasury Guarantees**

The Treasury guarantees the borrowing of several off-budget institutions that carry out the government's non-market lending activity based on public policy grounds. This includes the Student Loan Fund, the Regional Development Fund and the Housing Fund for Low-Income Families. The government borrows at market rates on behalf of these bodies who relend the funds at subsidised rates and often at great default risk. An annual appropriation is now made equal to the present value of the subsidy involved in their lending activity, to prevent future claims on the Treasury. The lending policies of the institutions concerned must now be constrained within the appropriations received each year. The treatment of subsidy costs within the Financial Statements is yet to be addressed.

The Financial Statements comprise a Balance Sheet and Operating Statement, together with a detailed reconciliation of accrued assets and liabilities to the cash budget. At this stage the Statements for Group A entities are limited to reporting on financial assets and liabilities. The classification of capital expenditures as assets and reflecting depreciation as expenditure in the operating statements is still being refined. The major component of these, namely property and accommodation costs, has been addressed via a mixture of historical reporting requirements and parallel reforms introduced in the late 1980s.

Accounting Law in Iceland has since 1966 required the publication every four years of a register of real estate and equipment assets (excluding infrastructure and national parks or monuments) with appropriate valuation (based either on property tax assessments or valuations for insurance purposes). There is therefore much information on the stock of property assets and their values. The creation in 1985 of a Treasury Property Agency provided the mechanisms for reflecting property assets more systematically within the governments financial statements on an accrual basis. With the creation of this agency (a Group B body) most of the governments real estate was transferred to its control, and away from the Ministries and Agencies occupying them. A form of internal market was established with properties "leased back" to departments and agencies at market rentals. As it constitutes a Group B agency, the Treasury Property Agency is required to operate and report along private sector lines i.e. full accrual accounting. Thus its asset portfolio of government properties must be reflected at market values in its balance sheet and depreciation reflected in its operating statement. Thus although the responsibility for property asset management has been moved "off-budget" the requirement for such agencies to report along private sector lines has imposed its own discipline and, in effect, resolved many of the perceived difficulties in reflecting asset values and depreciation within the Group A (on-budget) agencies.

An issue concerning which no resolution has been reached relates to both the validity and the process for valuing infrastructure assets and national monuments. No firm views have been reached at this stage.

## **Budgeting**

It has been decided, in principle, to present the Budget to Parliament on *both* an accruals and a cash basis. Thus Parliament will discuss and approve the government's financial activity on both accounting bases. The budget presented to the Parliament will include, for those on-budget agencies (Group A) and as appropriate for off-budget agencies (i.e. depending on the degree to which they derive either appropriation, borrowing or other authority from the budget which sanction their activities) both cash and accruals data using the same accounting standards applying to the Financial Statements. Data will be

presented in the budget documents along the same lines as the reconciliation statement proposed for the Financial Statements, i.e. the transactions disclosed for each on-budget entity will distinguish between the cash receipts/expenditure and the accrued receipts/expenditure (assets/liabilities) implicit in the cash transactions. Departments and agencies will also be required to prepare forecast Operating Statements following passage of the Budget. The rationale for adopting accrual accounting standards for the Budget is two-fold. First, it is considered essential that the same financial reporting system be employed for both the Financial Statements and the Budget. Second, it is not considered acceptable that the Treasury should incur future obligations without prior parliamentary approval. Such transactions should be authorised *before the fact* each year in the Budget. The continued use of the cash-basis of accounting in the Budget is considered essential for three reasons. First, planning with cash is more certain than under the accrual basis. Second, in-year control of expenditure is facilitated by the cash basis of accounting. Third, the monetary effects of treasury finances on the economy are captured more aptly with cash accounting.

## **Reporting and Consolidation**

It is proposed that the Budget and Financial Statements will each year separately report the finances of entities in Group A, Group B and Group C. Summary financial information will be presented in the Notes to the Financial Statements and the Budget for entities in Group D and Group E. The summary financial information for each enterprise will include its revenue, expenditure and profit; capital expenditure; assets, debt and owners' equity; and the size of the state's shareholding where applicable.

It is intended that consolidated financial statements will be prepared for each classification group of government entities (i.e. Group A, B, C, D, and E), but Statements will not be consolidated across groupings. In part this reflects the different scope and operating framework for each classification group and the perceived lack of net benefits for decision-making or accountability that would follow.

## **CONCLUSIONS**

Iceland has been involved in significant reform of its financial reporting and budgeting arrangements which, when fully implemented, will place budgeting and reporting in the public sector on almost a full accrual basis. As a result of both historical budgeting requirements and previous reforms much the "non-budget" sector has already embraced accrual accounting practices. Results however have not been systematically reported in the past. Nor were any mechanisms available to permit governments to identify and/or approve *ex ante*, the incurring of future liabilities. The new comprehensive classification system for government ensures that the government's financial reporting system encompasses all government activity. Reforms implemented in respect of on-budget Ministries and agencies will give effect to the original intent of the Budget and Accounting Act of 1966 and will ensure that the core public sector budgets and reports along similar lines to the other elements of the public sector. The consolidation of accounts for entity groups should permit an overview of the total economic and intergenerational impact of government activity. The reforms should assist in achieving the objectives of improved and more comprehensive public sector reporting and decision-making, better control over the magnitude and extent of long term liabilities; and more, effective and efficient financial management practices.



## **NEW ZEALAND\***

### **ACCOUNTING AND REPORTING BACKGROUND**

In October 1992, the first comprehensive set of accrual-based, annual Financial Statements of the Government of New Zealand were tabled in Parliament. The tabling was the culmination of two years work moving the Crown onto an accrual reporting regime.

The Crown was the last major public sector body in New Zealand to move off cash accounting. Most quangos (now called Crown-owned entities) have always used some form of accrual accounting and State-owned enterprises have used it since their establishment in 1986. The last department changed over in December 1990.

Local government territorial authorities have also improved their reporting practices and are now on their second year of accrual budgeting and reporting.

The remainder of this paper looks at what led to this change in practice and what moved New Zealand on from debate about the merits (or otherwise) of the accrual method of accounting. It outlines the rationale for accrual accounting in central government and the financial reforms that made it necessary. It then looks at the budgetary implications and the benefits to date. While the primary focus of the paper is on central government, substantial reform has also occurred in local government where a similar approach has been followed.

### **PUBLIC SECTOR REFORM**

Since 1984, New Zealand has undergone a comprehensive programme of economic reform. Virtually every sector of the economy has been subject to some change. Improving the performance of the public sector, at both central and local government levels, was part of this overall programme of reform.

In central government, the first major step was to separate commercial activities out of government departments and form State-owned enterprises. That process has been well documented and is not discussed here. By 1988 attention had turned to the core public sector and a set of changes that have become known as financial management reform.

#### **Financial Management Reform**

The financial management reform programme aimed to improve performance by enhancing the accountability relationship between Ministers and departmental chief executives. The four elements of the accountability model on which the reforms are based are:

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\* This annex is based on a paper presented by Dr. Ian Ball, Central Financial Controller, The Treasury New Zealand at a Conference of the Accounting Association of Australia and New Zealand in July 1992.

- clear ex ante specification of the performance required of chief executives;
- devolution of decision-making authority to give chief executives control over the acquisition, utilisation, disposal and mix of inputs;
- incentives on chief executives to act in the government's interests;
- ex post reporting of actual performance against specification.

In thinking about these elements two key distinctions were drawn: Ownership vs. purchase performance, and outputs vs. outcomes.

### **Ownership and Purchase Performance**

The ownership/purchase distinction came from the realisation that what is meant by performance depends, in part, upon the perspective from which it is viewed. In the private sector, a shareholder of a firm usually has different performance objectives for the firm than does a customer of that firm. The shareholder is concerned with maximising the return from the investment, while the customer is only interested in the product he or she is buying. In the case of departments, the Crown is both owner of the department and often the principal purchaser of the department's products (outputs).

### **Outputs and Outcomes**

Accountability implies that departments should only be held accountable for those things they can deliver. Consequently the New Zealand approach divides accountabilities so that:

- the chief executive is responsible for producing the outputs agreed with the Minister for the price agreed; and
- the Minister is responsible for the choice of outputs and, by implication, for their impacts on the community (outcomes).

To illustrate, consider road safety and assume that a reduction in road accidents is a policy goal (or outcome) sought by Ministers. They might seek to achieve this outcome by purchasing outputs from appropriate departments (or other suppliers). Relevant outputs might be road patrols, vehicle safety checks, road maintenance, and/or driver testing. They might also consider non-output interventions such as legislated speed limits, deterrent penalties, and alcohol taxes.

The chief executive is responsible for delivering the outputs agreed with the Minister (road patrols), not the achievement of the outcome (reduction in road accidents). The chief executive is able to control the production of outputs and can therefore be held explicitly accountable for these.

By developing the system in a way which gives Ministers greater powers to select outputs and output providers, the incentives on chief executives to produce outputs consistent with Government's desired outcome are stronger. There is also some concern that attempting to hold chief executives formally accountable for outcomes is unlikely to be effective, as their influence over outcome attainment is often limited by the impact of other factors, the time frames over which some outcomes emerge, and the poor knowledge of some causal relations between outputs (or other interventions) and outcomes.

## **Implications of this Performance Perspective**

The implications of this performance perspective quickly became apparent:

- the incentives on departmental permanent heads (as they then were) needed to change;
- departments needed much greater discretion over the acquisition, utilisation, disposal, and mix of resources they use to produce their outputs; and
- performance needed to be specified and reported on a basis which encouraged good purchase and ownership performance.

The State Sector Act 1988 and the Public Finance Act 1989 provided the legislative changes needed. Permanent Heads became chief executives, employed on 5-year performance based contracts, and directly accountable to their Ministers for their performance. The power to hire, fire, and determine pay levels was transferred from the central personnel agency to each departmental chief executive, making him or her the employer for that department. Control of other resources such as cash, capital expenditure and financial management information systems was also largely delegated to chief executives. The appropriation system changed to an outputs focus: Parliament now authorises Ministers to purchase the outputs they want, rather than granting cash appropriations for different categories of departmental expense (inputs).

## **ACCRUAL ACCOUNTING**

Accrual accounting was a necessary prerequisite for the measurement of both ownership and purchase performance:

- The ownership interest implied the same financial reporting used in the private sector. This includes distinguishing capital and current expenditure, and the use of full accrual accounting to monitor the performance of the Crown's investment.

Within a framework where the purchase and ownership interests are distinguished, the issue of whether or not to use accrual accounting to report on the ownership interest becomes as uncontentious as it is for owners of private sector entities.

- The purchase interest implied the same type of information as private sector sales contracts: quantity, quality, time and place of delivery, and price. Decisions about output pricing and production require information about total resources used (costs) not simply cash outlaid. This also requires accrual accounting.

The requirement for accrual reporting by departments was included in the Public Finance Act, as part of the obligation to comply with generally accepted accounting practice. Departments are required to produce a number of statements including:

Statement of Financial Position  
Operating Statement  
Statement of Cash Flows  
Statement of Objectives  
Statement of Service Performance  
Statement of Commitments  
Statement of Contingent Liabilities  
Statement of Accounting Policies

## **Financial Management Reform - Phase 2: Accrual Reporting by the Crown**

Recognising the potential flow-on effect of the departmental reforms to Crown reporting, the Public Finance Act required accrual based financial statements for the Crown to be produced from 1 July 1991. This allowed time for departments to implement the new regime and to produce reliable accrual based financial information. The first set of Crown Financial Statements prepared on an accruals basis, and in accordance with generally accepted accounting practice, were for the six months ending 31 December 1991. The first annual set, which were for the year ended 30 June 1992, were tabled on 13 October.

The primary purpose of the Crown Financial Statements is to assist Parliament and the electorate to hold governments accountable for their overall management of public resources. The statements significantly enhance the range of fiscal measures to assess the Crown's fiscal position. In particular, the additional information provides a clearer view of the longer-term fiscal consequences of current decision-making. Compiling and maintaining this information also ensures that public-sector managers remain conscious of the need to report Crown assets and liabilities accurately, and to manage them efficiently.

The Statements which are linked include:

- an Operating Statement showing the revenue and expenses of the Crown and the difference, termed the "operating balance";
- a Statement of Financial Position showing the Crown's assets and liabilities and the Government net worth, termed the "Crown balance";
- a Statement of Cash Flows reporting the cash flows from operations, investing and financing activities;
- statements of commitments and contingent liabilities, reporting the off balance sheet risks;
- a statement of borrowings, providing a detailed analysis of the Crown's debt.

## **Financial Management Reform - Phase 3: Crown Entities and Wider Crown Reporting**

The third phase of the financial management reforms is their application to other entities owned by the Crown. These include a wide range of other bodies known collectively as Crown entities. These range from school boards of trustees, to Crown research institutes, to regulatory bodies, such as the Commerce Commission and the Securities Commission.

Extending the financial management regime to this sector required decisions on which statutory bodies were owned by the Crown and which were not. Those bodies which are owned by the Crown have now been listed in a schedule to the Public Finance Act of 1989. The Act requires these bodies to report to Parliament on their service and financial performance in much the same way as departments. It also requires the Crown reporting entity to include Crown entities and State-owned enterprises from 1 July 1992. Half-year financial statements to 31 December 1992 have been produced on that basis.

## **Accounting Policies**

The Financial Statements of Departments and for the Crown as a whole are required to conform with generally accepted accounting practice (GAAP). A central element of GAAP is the accrual basis of

accounting. GAAP is defined in the Public Finance Act of 1989 to mean accounting practices recognised by the New Zealand accounting profession as appropriate and relevant for the reporting of financial information in the public sector. Private sector and overseas practice were adapted where appropriate. Where neither GAAP nor private or overseas experience was available, accounting policies specific to the item being reported were developed. The measurement base applied is historical cost adjusted for revaluation of many types of assets. An important concept applied in the recognition of transactions within the financial statements of Departments concerns whether control is exercised by the relevant agency over relevant assets and liabilities.

Annex A provides more details of the specific accounting policies applied by the Crown. It is appropriate to note here, however, the approach to the treatment of conservation, heritage and infrastructure assets from the perspective of the perceived difficulties which the valuation of these are seen to pose for countries considering the feasibility of whole of government reporting.

Reporting these assets on the balance sheet carries no implication that they are intended for sale. New Zealand has adopted a very pragmatic approach to the valuation of these assets; the balance sheets figures do not indicate their value in non financial terms. Valuation methods have been designed to produce a financial value, not a social or intrinsic one. Thus, for example,

- National Parks and Conservation Areas are valued (by government valuers) on the basis of sales of land in the same general location with comparable topography and vegetation, and are typically adjusted downward to reflect restrictions on use;
- State highways are valued on a depreciated replacement cost basis; replacement costs are based on government valuers estimates of the costs of new construction with an assumption of indefinite life for the formation of road structure. Values and depreciation are adjusted on the basis of local knowledge and the expertise of valuers who estimate the age condition and remaining life of assets.

Another interesting issue concerns the treatment of taxation powers and pension liabilities in the context of the balance sheet for whole of government. The power to tax is not treated as an asset. In reaching this position an analogy has been drawn with mutual or co-operative organisations with power to levy their members. In such cases the power to levy is not treated as an asset on the basis that members want to know the financial position of the organisation prior to the exercise of the power to levy. Similarly for government, users of the financial statements are interested in the financial position of the government before consideration is given to taxing powers. Even if the power to tax was regarded as an asset significant valuation problems are foreseen. Given that a minimum condition for inclusion in the financial statements is that information is reliable, valuation of the power to tax would be unlikely to meet this criterion.

Future payment of national superannuation and other social welfare benefits have not been included as liabilities on the basis that they are non-contributory benefits financed from general taxation and paid for at rates from time to time determined by the government. In contrast, the government's liabilities under the superannuation scheme for government employees are recognised.

### **Budgetary Implications of Accrual Reporting**

For the accountability relationship to be effective, it was considered that the budgetary process should be consistent with the ex post reporting approach. This had two major implications:

**Firstly**, ex ante and ex post performance information needed to mirror each other. Departments were therefore required to move both their ex post reporting and their ex ante budgetary

documentation onto an accruals basis. This meant including prospective financial statements as well as prospective service performance (output) information in the Estimates (annual Budget).

**Second**, the major budgetary incentive on departments, the appropriation process, needed to be consistent with the performance system.

Having an accrual based performance system does not necessarily imply accrual appropriations. It is conceivable that performance expectations could be established on an accrual basis, the cash impact assessed, and appropriations made for the cash required in the period. The perceived difficulty with this approach was that it would result in dual, potentially conflicting, performance objectives: accrual performance against accrual expectations; and compliance with cash appropriations. It would effectively have meant that the appropriation process would determine, rather than reflect, the criteria for departmental performance.

Further, the focus on cash failed to give Parliament effective control over the true consumption of resources - costs. Put another way, Parliament had an inadequate information base from which to authorise and scrutinise government activities.

The appropriation process adopted in New Zealand reflects both Parliament's need to control the Executive, and the performance expectations resulting from the Government's purchase and ownership interests in departments. Appropriations are made for:

- the purchase of goods and services (outputs) from departments, other agencies and third parties;
- capital injections to increase the Government's net asset holding in a department or agency;
- other payments of benefits and grants.

Depending on the degree of output contestability, the appropriation for output purchases could be on the basis of a market price. Presently, however, appropriations are made for the costs expected to be incurred in producing the output(s). That is the full cost measured on an accrual basis, including depreciation and an explicit charge (the capital charge -- currently set at 13% of the value of net assets) reflecting the cost of capital invested in the department.

Capital injections are appropriated and paid in cash in the year appropriated. Benefits and grants are also appropriated on a cash basis, although it is considered there may be merit in accrual appropriations as situations arise where an obligation to pay a benefit or grant occurs near the year-end, but the payment is not made until the following year.

### **Benefits at the Departmental Level**

The integrated nature of the financial management reforms mean that the benefit of the accruals focus is difficult to disentangle from other aspects. However, some of the more noticeable benefits are:

- By capitalising the costs of capital assets and depreciating them during their useful lives, departments can match the relevant portion of the capital costs to annual revenue flows. This enables the full costs of output production to be ascertained each year and compared between years.
- Costing of departmental outputs enables Ministers to make valid comparisons between alternative sources of supply in both public and private sectors.

- The output focus has given added impetus to the process of cost recovery for services which yield private benefits. It prompts questions such as:
  - . To whom is this service being provided?
  - . Should the recipient, or the taxpayer generally, be meeting the cost of that service?
- Full costing provides a better basis for cost recovery calculations.
- Budget rounds conducted with an output price focus are moving departments away from a cost plus mentality and have generated fiscal savings. For example, chief executives have been required to meet the cost of wage settlements (which they negotiate) from within their existing budgets. Output "prices" are not automatically increased just because there is a change in the price of an input.
- Departments are now much more aware of the need to actively manage their physical assets. Focusing attention on the balance sheet, together with a capital charge, is encouraging them to extract maximum value from the use of their assets and to review whether the assets held are needed to produce their outputs.
- Departments requiring new assets are not automatically given a capital injection to finance their purchase. They are first expected to examine whether the assets sought can be financed from within their existing balance sheet. This discipline is reinforced by the capital charge which is levied on the Crown's net investment in each department. This acts as a disincentive to a department to seek a capital injection unless it is satisfied that it can meet the incremental amount of capital charge through increased sales of outputs to the Crown, or to third parties.

### **Benefits at the Aggregate Level**

At the aggregate level New Zealand is only in the early days of accrual reporting. However, it is already clear that the Financial Statements provide a more complete picture of the Government's management of public resources. Because they report the assets and liabilities, and the revenue and expenses of the Crown, they provide high quality information about the financial consequences and long-term implications of government policies.

The real benefits are likely to occur over time when a history of the new measures is established. This will allow greater meaning to be derived from a single years results. The higher quality data will inform fiscal policy and the greater transparency can be expected to influence decision making.

### **CONCLUSIONS**

The New Zealand experience of accrual accounting has been positive. It has been part of a wider set of reforms that are enhancing the performance of the New Zealand public sector. The present Government instituted a review of the state sector management reforms, which reported in November 1991. This review endorsed the direction of the reforms, and proposed some changes to make them more effective. Amongst the more significant issues to emerge were the concerns on the part of Ministers that the collective interest was given insufficient weight, and that Ministers required more support in their relationships with chief executives. A trial use of Management Advisory Boards has been proposed as one option.

Accrual accounting is considered to have most value when it is viewed as a means rather than an end in itself. Accrual based financial statements for both Departments and the Crown as a whole are

considered to improve significantly the ability of Parliament and the public to assess the Crown's financial performance, as well as enhancing management decision-making on questions of performance. They contain a suite of fiscal measures which aid such analysis. The value of the Statements is expected to grow over time, as data over several periods permit trends to be observed and analysed.

## ANNEX A -- METHODS OF VALUATION AND DEPRECIATION\*

### A Valuation of Assets and Liabilities

Asset Type	Valuation Method
Cash and deposits	Face value
Receivables and advances	Cash amount expected to be collected
Inventories	Lower of cost and net current value <sup>4</sup>
Marketable securities held for	
Trading	Market value
Investment	Lower of cost and market value
Short-and long-term loans	Cost less provisions for uncollectable amounts
Equity investments	
Departments, Offices of ) Parliament and joint ventures)	Net asset value
State-owned enterprises )	
Other equity investments )	Lower of cost and net current value <sup>5</sup>
Land )	Net current value <sup>6</sup>
Buildings )	
Specialist military equipment	Depreciated replacement cost
Other plant and equipment	Cost less accumulated depreciation
State highways	Depreciated replacement cost
Commercial forests	Net current value
"Other" physical assets	Net current value (best estimate)
Intangible assets	
Identifiable (tradable)	Net current value (if future economic benefit foreseeable)
Non-identifiable (non-tradable)	Not recorded

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\*Source: Financial Statements of the Government of New Zealand for the year ended 30 June 1992.

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4. Net current value is the price at which an asset might reasonably be expected to be sold at balance data, less anticipated disposal costs.
  5. In some cases net assets are used as a proxy for net current value -- refer to Appendix B to the Financial Statements.
  6. Land is valued according to the New Zealand Institute of Valuers' standards, or otherwise pursuant to the Valuation of Land Act 1951.

## ANNEX A -- METHODS OF VALUATION AND DEPRECIATION (Continued)

<b>Liability</b>	<b>Valuation Method</b>
Overdrafts, payables, and current provisions	Face value
Pensions	Latest actuarial valuation adjusted for subsequent changes in value
Borrowings	Nominal value adjusted for unamortised portion of premium or discount on issue
Finance leases	Present value of minimum lease payments

### **B Depreciation of Assets**

<b>Asset Type</b>	<b>Depreciation Method</b>
Buildings ) Plant and equipment )	Straight-line at specified rates
State highways	Approximation of physical deterioration
Intangible assets	Amortised over period of expected benefit
Assets under finance leases	Amortised according to expected benefit from use of the asset
Leasehold improvements	Amortised over unexpired period of the lease or estimated useful life of improvements, whichever is the shorter

### **C Revaluation of Assets**

Physical assets are revalued at least once every three years unless the change is immaterial or the cost of revaluation is likely to exceed the information gain. The accounting treatment of revaluations is outlined below:

- . Increases in the net carrying amount<sup>7</sup> of assets are credited to a revaluation reserve for that asset class. To the extent that such a revaluation reverses a prior decrease in value charged to the Operating Statement, then the increment is first credited to that Statement.
- . Decreases in asset values are charged to any prior revaluation reserve created for that asset class, and any residual debit balance is charged to the Operating Statement as an expense.

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7. Net carrying amount is the initial cost or valuation of an asset adjusted for additions, improvements and disposals, less depreciation and amounts written off to date.

# UNITED KINGDOM

## ACCOUNTING AND REPORTING BACKGROUND

Budgeting and financial reporting for the 'core' (non commercial) elements of the UK public sector has traditionally been on a cash basis. The cash (Vote) accounting system involves Parliament voting an annual grant to Departments on the basis of estimated payments and receipts within a year. An appropriation account is prepared at the end of each year for each 'vote' to enable actual payments and receipts to be compared with voted amounts. Vote accounts only record cash movements -- receipts and payments are recorded as money is received or paid by departments. Accountability under this system is the responsibility of Accounting Officers (senior officials) in each Department who are appointed by the Treasury and are answerable to Parliament for bringing expenditure to account and for creating a system of financial management which ensures regularity, propriety and value for money.

The position in the commercial parts of the public sector has been different. Even before many of these were privatised, nationalised industries had for many years prepared accrual accounts along private sector lines reflecting the commercial nature of their activities. Likewise those parts of departments engaged in activities such as ship repairing, engineering, manufacturing, trading and other commercial or quasi-commercial activities have also prepared their accounts on this basis for many years. The trading funds established in the 1970s did likewise. However for the traditional areas of government, although there were previous attempts to introduce accrual accounts in some parts of the "core" public sector, wide ranging requirements have only been imposed quite recently. Since their launch in 1988 Executive Agencies have been expected to prepare and publish commercial style accruals accounts. Consideration is currently being given to extending similar arrangements to departments.

This paper does not consider accounting developments in the local authority sector. Local authorities currently account on an accruals basis for current expenditure and on a cash basis for capital expenditure. The professional institutions for local authority accounts, the Chartered Institution of Public Finance and Accountancy (CIPFA), are preparing for full implementation for 1994-95 of a new code of practice, which aims to bring local authority accounting more closely into line with commercial accounting practice. The new code will require local authorities to move to an accruals basis of accounting for all expenditure.

The remainder of this paper focuses on accrual accounting developments in the 'core' government sector i.e. departments and agencies. The origin of these more recent developments can be traced to, and need to be considered within the context of, broader public sector reforms in the UK.

## PUBLIC SECTOR REFORM

Improving the efficiency, output and outcome performance of the public sector in the United Kingdom has been a high priority for the UK government over the last decade. A number of public sector management initiatives have been directed toward these ends.

The **Financial Management Initiative (FMI)** launched in 1982 marked the start of a general and co-ordinated drive to improve financial management in government departments. One of the key aims was to devolve responsibility for budgets and financial control to line management units and to individuals wherever possible. It emphasised the need for managers at all levels to have:

- (i) Clearly defined objectives;

- (ii) Responsibility for the best use of resources (including a critical scrutiny of outputs and value for money);
- (iii) Information particularly about costs and the achievement of objectives; training and access to expert advice.

Building on the FMI, the **Multi-Departmental Review of Budgeting (MDRB)** (1986) focused inter alia on the need for top management to set priorities, manage resources and review performance, and for achievements to be evaluated regularly. The **Government Purchasing Initiative (GPI)** (1984) arose from the recommendations of the "Government Purchasing" report. Its aim was to develop professionalism in government purchasing and to establish a unit to provide advice to departments on how to improve value for money through best practice. This unit's role was expanded in 1986 to include project management. **Running Cost Limits** (1985) were introduced to keep expenditure on administration under proper control, to continue the downward pressure on these costs and encourage the search for greater efficiency. The **Next Steps Initiative** (1988) whose aim is to deliver Government services more efficiently and effectively within available resources, for the benefit of taxpayers, customers and staff, built on the principles of the FMI and the MDRB, in particular through the enlargement of management discretion within a strategic framework including performance and accountability.

This initiative includes devolution, to the greatest extent practicable, of the executive functions of government to Agencies. Chief Executives of Agencies are appointed by Ministers and are directly and personally responsible to that Minister for the performance of the agency.

The government, through the **Citizen's Charter** (1991) is also committed to a programme of change and improvement to raise the standard of public services and make them more responsive to their users.

## **ACCRUAL ACCOUNTING**

The launch of the financial management initiative in 1982, the widespread development of delegated budgetary responsibility, and the subsequent initiatives including the setting up from 1988 onwards of executive agencies all represented fundamental steps leading to a refinement of existing, and development of new, financial management procedures and accounting arrangements. From the commencement of reform initiatives it became increasingly clear that there were difficulties in reflecting the achievement of value for money (VFM) in a cash system the primary purpose of which is to obtain the necessary funds from Parliament.

In particular, the traditional system excluded from managers purview or control a number of non cash resource items (e.g. depreciation, cost of capital, debtors, creditors, stock balances, rents, superannuation etc.) which were considered relevant, to varying degrees, to achievement of the broader results oriented goals set for managers under various reform initiatives. The focus, and assessment of performance, on the basis of VFM criteria implied the need for financial management information which showed how total resources were applied and managed in addition to information on cash payments and receipts.

In recognition that the vote accounting system could not fully reflect these performance requirements a number of adaptations and additional requirements were introduced progressively during the 1980s.

**(i) Non-cash Items were brought into the Cash Accounting System**

The main examples of this were:

**Opportunity cost rentals**

The introduction in 1983 of a Property Repayment Services (PRS) Scheme was one attempt to more fully reflect within the cash budgeting system the resources which departments consumed in the provision of public services. This involved departments whose accommodation needs were centrally provided being required to pay opportunity cost rentals (OCR) from their running costs appropriations which were adjusted accordingly. OCR were, in effect, shadow prices calculated to reflect market rentals.

**Superannuation**

Managers are increasingly being given delegated responsibility for budgets. In order to ensure budgets include all costs, accruing superannuation costs are now charged to all departmental running costs budgets from 1 April 1993. This further adapts the cash budgeting system to take account and make managers aware of accruing liabilities with respect to staff in their resource allocation decisions.

**(ii) Supplementary Accruals Based Information was Produced**

**Memorandum trading accounts**

To stimulate the search for efficiency, departments have been required to pursue options for charging; both externally to the public and internally, within and between departments. In recognition of the need to take account of full costs in setting charges Department have been required to prepare, since 1983, Memorandum Trading Accounts (MTA) in respect of chargeable services. These are accruals based accounts which are prepared for internal use. They are intended to provide departments with an additional means to forecast and assess actual performance for chargeable services. They consist of a quasi operating statement for the service in question prepared on the basis of full costs i.e. they incorporate such accrued costs as depreciation, accommodation, cost of capital and superannuation.

**Capital asset registers**

Follow a Ministerial decision in 1990, all Departments (including their agencies) have been required to establish capital asset registers with an implementation target date of 1 April 1993. These registers will facilitate the provision of asset values from which can be calculated the cost of using capital (i.e. depreciation and interest) thus providing vital input for the preparation of accrual accounts. Valuation guidelines require the use of current asset values, and the adoption of best professional valuation practice.

**(iii) Additional requirements calling for accrual based rather than cash based information were made**

**Market testing**

The UK White Paper on "Competing for Quality" (1991) requires departments actively to pursue market testing. Market testing aims to expand competition in the public sector by providing incentives

(retention of savings) to managers to buy services from the most advantageous supplier, whether the existing in-house team or outsiders. For competition to be possible managers need compute the full cost of providing relevant services in house which include accrued costs such as depreciation and interest on capital.

## **Executive Agencies**

The establishment of executive agencies from 1988 represented a major structural shift in favour of applying accrual accounting within the public sector. A key objective of the initiative is improved stewardship reporting to Ministers, Parliament and the wider public; stewardship in terms of accountability for the effective management of total resources at the disposal of agencies in the provision of good quality services. The policy presumption is that all agencies will produce and publish, with their annual reports, commercial style accounts on an accruals basis. An essential feature of agency arrangements is the setting of key performance targets by Ministers including those relating to output, quality of service, efficiency and financial performance. It is on the results achieved against these that the performance of Agency Chief Executives is judged. Framework documents for agencies require an initial review to be completed after, typically, some 3 years. This process covers performance as well as alternative means of providing the service. Where agency status is confirmed a revised framework document is published.

Agencies operate either on-vote within the normal Parliamentary supply controls or off-vote as trading funds (under the Government Trading Funds Act 1973, as amended - see below). Agencies operating on-vote may be subject to gross or net running costs control. The Chief Executives of both types of agency are appointed Accounting Officer and are accountable to Parliament for the management of their resources.

**Supply financed agencies** cover a wide spectrum, ranging from Agencies whose receipts cover all their costs to Agencies which rely on voted expenditure to cover their operating and capital requirements. Most expenditure by Agencies is controlled gross. However, where costs are recovered through related charges and it is possible to use other control mechanisms including satisfactory performance targets covering financial performance, quality of service and efficiency, Agencies may be exempted from gross running costs control, although their net running costs expenditure remains subject to cash limits control.

**Trading Funds** provide a financing framework for agencies whose revenue consist principally (more than half) of receipts arising from payment for services rendered. Before a trading fund can be set up the responsible Minister needs to be satisfied that setting up a trading fund, which means its expenditure and revenue cease to be subject to detailed Parliamentary control through the Vote accounting arrangements, will lead to improved management efficiency and effectiveness. Unlike supply financed agencies trading funds have powers to borrow to meet capital expenditure and their other financing requirements and to establish reserves. Parliamentary control is retained through affirmative Orders establishing each fund, scrutiny of statutory accruals based accounts and the power to examine the trading fund's Accounting Officer.

In terms of financial performance targets, **trading funds** are set each year an external financing limit. This covers borrowing, major capital expenditure the use of reserves and distribution of surpluses. The main targets are quasi-commercial ones. These include for example the requirement to break even taking one year with another and to earn a specified rate of return on average capital employed in the fund (before interest and dividend payments). For bodies whose fees are fixed by regulation this is set at not less than 6 per cent in real terms; for funds who are competing with private sector suppliers, the rate of return is set at not less than 8 per cent in real terms thus providing these types of funds with additional competitive and efficiency pressures. For **supply financed agencies** which charge for their services and are in a position to recover all their costs the target is to break even after all costs have been met (including

the consumption of capital resources and the cost of capital). All Agencies are set demanding efficiency targets, based for example on unit costs, irrespective of whether they are operating on or off-Vote and are required to prepare commercial style, i.e. accruals based, accounts and reports.

The purpose of introducing these new financial management arrangements has been to enhance the responsibility and answerability of the Chief Executives of Agencies; to ensure that managers of Agencies have available to them the systems and information necessary to meet the needs of their business; to enable Agencies to deliver services more efficiently and effectively, within available resources, for the benefit of taxpayers, customers and staff; and to increase the openness and accountability to Parliament of those parts of Government departments operating as Agencies. Accruals have been seen as necessary in this context to ensure full costs (including consumption of capital) are charged to customers in a systematic fashion; that there is a clear picture of the underlying financial position of the business; and, that management has the information available to them to manage the business in a more cost effective manner and achieve their key financial and other performance targets.

### **Accounting Policies**

All agencies are required to produce and publish annual reports and accounts. These must include:

- an operating/income and expenditure statement;
- a balance sheet or a statement of the assets and liabilities (where appropriate);
- a cash flow;
- notes to the accounts which should include a statement of performance against key corporate financial targets.

Agencies are expected to base their accounts on:

- (i) the accounting concepts of prudence, consistency, materiality, matching/accruals;
- (ii) full costs including non-cash costs such as depreciation;
- (iii) up-to-date land and building valuations;
- (iv) current values (normally net current replacement costs) for plant and machinery;
- (v) the lower of current replacement cost or net realisable value for stocks.

The prescription of accounting requirements for the government sector in the UK is a matter for the Government. However where public sector bodies prepare accrual reports and accounts on commercial lines, the Government has sought accord with principles underlying the pronouncements of UK Accounting Standards Board, modified, as necessary, to reflect the special nature of some public sector bodies. Moreover, the Government has sought to ensure that as far as possible, in the setting of standards, the Board takes into account the concerns and special features of the public sector, so as to enable standards to be applicable to both public and private sectors.

The Vote accounts of all departments are audited by the **Comptroller and Auditor General (C&AG)**, as are the accruals accounts of all trading funds and vote financed agencies under directions issued by the Treasury. The C&AG may also conduct VFM studies on these bodies. All audited accounts of agencies are laid before Parliament. [The legislation governing the preparation, audit and laying of trading fund accounts is the **Government Trading Funds Act (1973)**; that governing the accounts of supply-financed agencies, once invoked, is the **Exchequer and Audit Departments Act (1921)**

(Section 5)]. In case of supply financed agencies Parliament's primary control continues to be through the approval of the Estimates provision and appropriation accounts.

Trading Fund agencies are required to have accruals systems in place to facilitate accruals reporting from their first day of operation as a trading fund. For supply financed agencies the presumption is that these systems will be developed in time to produce auditable accruals accounts for the second year of operation.

## **DEPARTMENTS**

The focus for Departments remains the cash accounting system. However, in the same way as for agencies, the requirements for efficiency in resource allocation and value for money in service provision are of primary importance.

### **Departmental resource accounts**

Public management reform has demonstrated that traditional cash accounting arrangements while always essential for the purposes of controlling cash, are not the best or most appropriate mechanism to permit value for money assessment in departments. This has been reflected in the requirements to develop capital asset registers, to introduce charging arrangements within departments for internal services and to create greater accountability for non cash costs such as opportunity cost rentals and superannuation. While modifications have in some instances been effected within the cash system to deal with these (e.g. opportunity cost rentals and, superannuation), there is, as yet, no satisfactory mechanism for dealing with depreciation of capital assets, interest on capital or internal charges within the cash budgeting system. The concern is that further adaptations to the cash accounting system so as to reflect within it various accruals information requirements, risks making that system so complex that it may jeopardise its clarity and effectiveness as a cash control mechanism.

It is against this background that the Treasury is currently examining, by way of a pilot study in a number of departments, the extension to departments of accrual accounting arrangements (titled departmental resource accounts) similar to those applying to executive agencies, as a supplement to traditional vote estimates and appropriation accounts. It is important to recognise that this development is still only at the pilot-testing stage.

Departmental resource accounts would be based on a hierarchy of accrual accounts within a department, the top slice of which would form the resource account itself. Resource accounts would incorporate all costs, both cash and non-cash, and would be analysed in a way that links costs to outputs and, where practicable, departmental objectives.

Whether or not they are eventually introduced will depend upon an assessment of the outcome of the pilot studies and, in particular:

- their demonstrable usefulness to departments in terms of allocating resources and their potential to improve value for money;
- assurance that they are not prohibitive in terms of cost of introduction;
- their perceived value to users of departmental information (Select Committees, MPs, academics and the public) in terms of enhancing accountability.

## CONCLUSIONS

Public sector reform in the UK involving reduced detailed controls over managers; greater flexibility in resource use; making managers more accountable for performance within a clear framework of objectives and resources; and, the underlying pre-eminent objective of producing value for money in public services, have clearly demonstrated the need for additional more robust indicators of financial performance than traditional cash based accounting arrangements can provide. New accrual based financial reporting is seen as an adjunct to traditional cash reporting (not a replacement for it) which will enhance the tools available to assess and reflect performance in value for money terms.

The creation of Executive Agencies contained the main structural shift in recognition of the need for accruals based data as a means for managers to plan, address and be accountable for performance in value for money terms. It has also provided additional means for Parliament and users of public services more objectively to assess public sector performance.

The presumption is that the application of accruals accounting in agencies brings real benefits to agency management and the accountability process. It is intended that assessment of the adequacy of, inter alia, accounting systems for these businesses (and therefore improved value for money) will feature in initial reviews of individual agency framework documents.



## UNITED STATES

### ACCOUNTING AND REPORTING ENVIRONMENT

The US budgeting system is primarily based on obligations or cash or cash equivalents. However, it incorporates a number of modifications which introduce accrual elements to the cash budgeting system. Such arrangements have aimed to place activities involving such costs with future cash disbursements on the same footing as normal cash expenditure.

For many years accrued interest on public issues of public debt has been reflected in the cash budget.

Under the Credit Reform Act 1991, the subsidy elements (both credit risk and interest rate) of loans and loan guarantees are imputed as expenditures within the budget. An appropriation is established for a cash amount which measures the extent of the likely cost to the government of the loans and guarantees (the credit subsidy equivalent). Departments and agencies are constrained to respect this subsidy limit when issuing loans or guarantees. Similar reforms were proposed in the 1992 Budget to bring to account within the budget the accruing costs of federal deposit insurance and other insurance programmes.

Recent reforms to the budgetary accounting for lease purchases and leases of capital assets require departments and agencies to obtain budget authority reflecting the full amount of the governments estimated legal obligations under the relevant lease arrangement comprising the asset and imputed interest costs prior to entering into the arrangements.

Financial reporting requirements for federal departments and agencies are established and guidance provided by several organisations. These organisations have traditionally had different objectives for accounting and financial reporting and thus have frequently established different requirements. The **Office of Management and Budget (OMB)** is responsible for preparation of the annual budget for the Federal Government. It prescribes the manner in which agencies must account for and report budgetary transactions. These budgetary accounting rules are essentially cash based and include requirements to report, generally monthly, on the progress of spending. **Treasury** is responsible, inter alia for collecting revenues and making payments. Many of these financial and accounting functions are delegated to agencies and the Treasury therefore prescribes certain accounting and financial reporting requirements. Much of this information is cash based showing financial activity against appropriations. Treasury also publishes a prototype consolidated financial report for the government as a whole which is accrual based and developed from statements of financial position, operating statements and other information sent to it by agencies. The form and content of these reports are defined by Treasury in its Finance Manual.

### PUBLIC SECTOR REFORMS

A perceived need to further reform accounting and financial reporting requirements has developed as a result of the implications of public sector management reforms introduced progressively over the last decade. In particular, concern has developed that existing requirements with their inherent fragmentation and focus on compliance might not adequately be satisfying user needs; both management needs in terms of day to day decision-making and external users needs (Congress and the Public) in terms of demonstrating accountability for the efficiency and effectiveness of federal programmes.

Since 1981, the Federal Government has undertaken a comprehensive programme of management improvement. Particular emphasis has been placed on:

- modernising financial systems and practices to levels comparable with those in the private sector;
- simplifying government administration and reducing its cost; and
- improving the efficiency of programmes that provide services to the public.

The management improvement programme has been advanced through a number of largely separate initiatives. They have focused on areas such as government lending practices, financial management systems, government contracting procedures and rules, employee productivity, and improved project monitoring and evaluation. Two major recent initiatives stand out in terms of their (potential) influence on the nature and extent of financial reporting requirements. They are the implementation of the Chief Financial Officers Act of 1990 and the establishment of the Federal Accounting Standards Advisory Board (FASAB).

### **Chief Financial Officers (CFO) Act**

The CFO Act seeks to establish a formal, integrated structure for financial management activities in federal agencies. Implementation of the Act involves a comprehensive effort aimed at correcting long-standing shortcomings in financial systems, internal controls, the use of assets, and at producing more reliable and useful financial information. The objective is to work towards a financial management system which will eventually provide the basis for increased management flexibility and clearer accountability.

The legislation created a Deputy Director for Management within OMB as the chief official responsible for financial management in the federal government, as well as for procurement, regulatory and general management activities. The Act also required the appointment of a Chief Financial Officer (CFO) in 23 agencies. CFO's are required inter alia to establish:

- effective financial policies and internal controls which include compliance with applicable accounting standards; and preparation and revision of 5 year financial management plans.
- systems which produce useful, reliable and timely financial information including development and reporting of cost information; systematic measurement of performance (both efficiency and effectiveness); and on asset management.
- useful financial analysis and performance reports which comply with applicable requirements including accounting principles and standards.

The Act establishes a strategy for the production of Audited Financial Statements -- beginning with revolving funds trust funds and commercial activities, and ten pilot agency-wide statements covering all activities (both commercial and non-commercial). The Act requires performance measures (outputs, efficiency [including unit costs] and outcomes) to be part of the Statements.

### **Federal Accounting Standards Advisory Board**

The Federal Accounting Standards Advisory Board (FASAB) was established in 1990 by memorandum of agreement between the three major organisations having powers in relation to accounting and reporting by Federal agencies -- i.e. OMB, Treasury and the General Accounting Office (GAO). The mission of the FASAB is to recommend accounting standards to its three principals after consideration of the financial and budgetary information needs of congressional oversight groups, executive agencies, and the needs of other users of federal financial information.

In establishing the Board, it was explicitly recognised that federal accounting standards and financial reporting play a major role in fulfilling the government's duty to be publicly accountable and can be used to assess (1) the governments accountability and its efficiency and effectiveness and (2) the economic, political and social consequences of the allocation and various uses of federal resources. Implicit in this was the acknowledgement that existing accounting and financial reporting requirements and procedures for establishing them were not sufficiently meeting objectives; and that the federal government had no integrated mechanisms for reporting within the context of those objectives.

## **ACCRUAL ACCOUNTING**

It is clear that both establishment of FASAB and the passage of the CFO Act will have important implications for future federal accounting and financial reporting requirements. In particular these are likely to involve the increasing use of accruals based financial statements.

## **CHIEF FINANCIAL OFFICERS ACT - CURRENT REPORTING REQUIREMENTS**

The enactment of the CFO Act called for the production of financial statements that fully disclose federal entities' financial position and results of operations, and which provide information for both the effective allocation of resources and with which Congress, agency managers, the public and others can assess management performance and stewardship. OMB with input from other interested parties has developed formats and instructions for comprehensive (accrual-based) financial statements to give effect to these objectives.

### **Coverage**

Separate annual financial statements are required to be prepared for each reporting entity in an agency. Agencies have the flexibility to define the reporting entity in a manner that results in the most useful presentation of financial information. In its broadest sense, a reporting entity can be an entire agency, bureau or other organisation that represents a meaningful unit for programme management. In its narrowest sense, a reporting entity can be a single revolving fund, trust fund, or commercial operation. Each entity's statements must include all costs incurred by the entity in support of its activities.

Initially, the preparation accrual-based financial statements have been mandated for all agencies' (departments) revolving fund, trust fund and commercial activities. In addition, ten pilot organisations are required to prepare organisation-wide financial statements covering all Departmental activities. Subsequent implementation stages will involve extension of the requirement for organisation-wide statements to all Federal departments.

### **Format**

OMB have issued detailed guidance on the form and content of financial statements which agencies are required to conform to. Agencies are, however, permitted at their discretion to modify their Statements should variances be required to allow the financial statements more accurately to reflect the financial operations and conditions of the reporting entity. Such modifications have been limited to those which would improve disclosure by the application of the financial reporting practices of similar activities in the private and State and local government sectors, or accounting principles promulgated by authoritative standard setting bodies and other authoritative sources.

Each of the annual financial Statements must comprise:

- . an overview of the Reporting Entity providing a brief description of the reporting entity which includes, among other things, an analytical review of relevant financial and performance data of the programmes, activities and funds that comprise the reporting entity. Where possible financial data is required to be related to other measures of performance on a programme by programme basis in order to facilitate use of the financial statements to assess both financial and programme performance.
- . Principal Statements and Related Notes consisting of a:
  - **Statement of Financial Position** which incorporates a requirement to classify and aggregate liabilities based upon whether they have been explicitly funded through the budget or not. The funds that would be required in the future to liquidate unfunded liabilities are reported in the Statement of Financial Position as an offset to the reporting entities net position. However, there is intended to be no implication or requirement that the Federal Government would provide funds to liquidate these liabilities.
  - **Statement of Operations** including the requirement to report operating expenses by programme.
  - **Statement of Cash Flows**
  - **Statement of Budget and Actual Expenses** providing a comparison, by programme, of actual expenses against budget provisions and a reconciliation of actual expenses on an accrual basis with expended (cash) appropriations.
  - **Notes** to the principal Statements to provide such additional disclosures as are necessary to make the Statements informative and not misleading.
- . Combining Statements where feasible and appropriate which present by major programmes, activities or funds the information presented in the principal Statements. Agencies have the discretion to determine the most appropriate level of disaggregation based on their assessment of its usefulness to programme managers, financial managers and other users.
- . Supplemental Financial and Management Information which supports information presented in the Overview or which would otherwise enhance understanding of the financial condition of the reporting entity e.g. tables or financial and programme data not considered appropriate for inclusion in other parts of the statements.

## Accounting Principles and Standards

Following detailed consultations OMB have received the concurrence of the American Institute of Certified Public Accountants to recognise the form and content of federal agency financial statements as another comprehensive basis of accounting. In this regard, and in terms of applicable (accrual) accounting standards, OMB have established a hierarchy of accounting principles issued by approved Standard setting bodies, which agencies must adhere to in preparing financial statements.

The hierarchy requires that agencies adhere to the accounting standards set by the following bodies in descending order of priority:

- . FASAB
- . Private sector accounting bodies [i.e. the Federal Accounting Standards Board]

- . State and Local Government Accounting Standards Boards;
- . Other authoritative sources or standard setting bodies.

At the current stage of its deliberations FASAB has not proposed any final accounting standards. Accordingly, so as to provide a benchmark for preparing financial statements, agencies have been instructed to continue using the applicable accounting standards currently in effect consistent with the hierarchy established by OMB. These are largely based on standards issued by the relevant private sector accounting bodies, varied as appropriate by individual agencies so as to improve disclosure and consistency with similar activities in State and local government sectors and other authoritative standard setting bodies.

### **Costs and Benefits of Preparation of Financial Statements**

It is expected that the development of financial management systems to support the preparation of comprehensive financial statements as well as the discipline necessary to prepare the statements will lead to the production of more timely, reliable, and useful financial information for use throughout the government and externally.

In this regard the Statements are intended to be the culmination of a systematic accounting process which incorporates an accrual-based accounting system that is an integral part of the total financial management system departments should be developing and which contains effective internal controls and reliable data.

An important consideration in the adoption of more comprehensive reporting for agencies is the need to ensure additional benefits deriving from the information contained in them does not exceed the cost of implementation. The CFO Act requires OMB to report on the costs and benefits associated with preparation of financial statements. Each agency is required to establish a system for tracking and recording the costs of preparation of financial statements by fiscal year, as well identifying (in dollar terms where possible) the benefits derived from the preparation of financial statements e.g. evidence of the need for improved financial systems, improved data integrity, and instances of support for decision-making.

### **Relationship to other Reporting Requirements**

An important aspect of the reporting requirements established by the CFO Act is agreement reached by OMB, Treasury and GAO that their existing accrual based reporting requirements should be consolidated and subsumed under the umbrella of the CFO requirements.

Thus the data presented in annual financial statements prepared in accordance with the CFO Act will be used as the source data for meeting the requirements of the Treasury for its preparation of consolidated accrual based financial statements for the government as a whole.

The form and content of Federal financial statements required by the CFO Act as well as those required by Treasury will evolve as accounting and reporting issues of the Federal financial community are addressed by the FASAB. The next section examines FASAB considerations to date and their implications for future financial reporting.

### **FASAB CONSIDERATIONS - IMPLICATIONS FOR FUTURE REPORTING**

On 8 January 1993, the Board issued an Exposure Draft of a proposed conceptual statement on the objectives of federal financial reporting, including a detailed analysis of their context, rationale and

implications for financial reporting. The Draft considered the needs of both internal and external report users and the decisions they make.

The Board has identified accountability and decision usefulness as the fundamental values of government accounting and financial reporting which provide the foundation for establishing the objectives of federal financial reporting. It has concluded that financial reports should assist assessment of accountability of the government for its integrity, performance and stewardship. Similarly governments are accountable for operating economically, efficiently and effectively. Those who implement government policies and programmes are considered to need appropriate information to enable them to plan, control and conduct government operations in the pursuit of these.

The users of financial information have been classified as falling into four major groups: citizens; Congress; executives (including the President and agency heads); and programme managers. The needs of users has been categorised as falling within four broad categories as to the type of financial information needed. Users have been identified as requiring information on Budgetary Integrity; Operating Performance; Stewardship; and Deterring Fraud Waste and Abuse. The information necessary to achieve these differing objectives has implied to the FASAB a requirement for a range of financial information beyond that which existing reporting provides.

Achievement of the objective of budget integrity is seen to require information which fulfils the government's duty to be publicly accountable for revenue raised and their expenditure. This should include information on how budgetary resources have been obtained and used and whether this was within legal authorisation; the status of budgetary resources in relation to obligations and whether funds were expended for appropriate purposes; and, how budgetary resource information relate to the full cost of programme operations including consistency with information on assets and liabilities.

To facilitate decision-making and accountability for operating performance the FASAB considers financial reporting should enable users to determine, the full costs of providing specific programmes and activities and the composition and changes in those costs; the efforts and accomplishments of programmes (and their relation to costs) in terms of inputs, outputs and outcomes compared with goals as well as programme efficiency and effectiveness; the efficiency and effectiveness of the government's management of its asset and liabilities.

The objective of stewardship is seen to require financial reporting which enables assessments of whether the government financial position (in terms of assets, liabilities and net assets) improved or deteriorated; whether future budgetary resource will be sufficient to sustain public services and meet future obligations as they come due; and, whether government operations have contributed to the nation's current and future well being.

Meeting the objective of deterring fraud, waste and abuse is viewed as requiring information which assists users in understanding whether adequate financial management systems and internal controls are in place.

FASAB consideration are at a relatively early stage; the Board has not yet recommended the accounting statements or concepts to support these objectives. Nevertheless the implications are that future financial reporting will involve financial statements that are quite unique. More than one measurement focus will be necessary to achieve the objectives (i.e. cash and accruals), which will involve a suite of statements which, while not fully integrated with one another, are related like a family. Current thinking on the nature of the statements is discussed below.

The first set of financial statements on budget integrity would comprise statements describing financial resources. Financial resources might be shown as a working capital statement showing both funds provided by the Congress and funded liabilities (obligations for which funding has been agreed by

Congress). Changes in financial resources would be shown in a statement similar to a private sector cash flow statement. This would track the monies provided and the monies expended and show at the end of the period the net change in the financial resources entrusted to the agencies. Statements of financial resources might be tied to the cash budget; alternatively they could be tied to budget authority (obligations) in order to get fuller accountability and enable the setting of accrual targets.

The second set of statements, the operating performance statements, would be constructed to help evaluate efficiency and effectiveness. They would comprise operating statements for individual government programmes that are aggregated at the various management levels of the agency, at the agency level and, finally, for the government as a whole. The operating statements would reflect the use of financial resources, but also pick up costs related to the use of other assets that are acquired by the agency with the money provided by the Congress as well as unfunded liabilities. However only those amounts necessary for measurement of the efficiency and effectiveness of the government programme, fund or agency would be included. It is for this reason, the statements would track the flow of costs (accruals) which would be the measurement focus for these statements.

The programme operating statements would separately indicate those elements of cost which can, or should be, subject to performance measurement or other types of efficiency or effectiveness measurements, and would be separated into broad categories of operating expenditures and capital expenditures. Within the operating expenditures category it is envisaged that entitlements, would be shown separately from programme operating costs. Similarly, within capital expenditures, expenditures for federal activities would be separated from development expenditures made to benefit the private sector or otherwise improve the GNP. This separation is considered desirable because different performance criteria apply to each of them and also because each of them has a different budget and economic relevance.

Operating performance statements showing these items would reflect the use of financial resources by the programme, fund or agency, but would also include the use of other resources that were purchased in prior periods. For example operating statements would include the use of consumable inventories and depreciation for certain kinds of assets, namely those capital expenditures that are made for commercial activities where profit measurement counts or for multipurpose facilities like office buildings and computers where good lease-buy decisions could be adversely affected by failure to capitalise.

The operating performance statements would also include an agency balance sheet. The agency balance sheet would tie in with the individual programme operating statements, and therefore, except for financial resources, would reflect the residuals of the flow of costs. Components of the balance sheet would be limited to assets and liabilities, the capitalisation of which is necessary to enable assessment of efficiency and effectiveness. In the case of assets this would include capital assets related to commercial activities or multipurpose facilities. Other assets, such as defence equipment, infrastructure assets, human capital, research and development expenditures would be expensed in the operating statements on the basis that while knowledge of the amount of spending is important it is not appropriate or necessary to capitalise them in order to make appropriate judgements about efficiency and effectiveness.

In the case of liabilities, again only those claims on future budgets which bear on assessments of efficiency and effectiveness would be included. Thus, for example, accruing costs of federal employees (e.g. superannuation etc.) or the costs of cleaning up nuclear power plants would be included, while actuarial assessments of social security liabilities would be excluded.

The third set of statements -- Stewardship Statements -- would augment the operating balance sheet with information that is necessary to establish full stewardship responsibilities for the Government as a whole. The objective of this statement would be to establish accountability for all resources and all obligations at the end of an accounting period by extending the operating balance sheet to cover all the assets and liabilities of the Federal Government to permit an assessment of the nation's financial condition.

Considerable work has been undertaken by OMB in attempting to define how such a "whole of government" Statement of financial position would be constructed; a diagrammatic construction of this is presented at Appendix 1. It proposes a threepart construct; each part representing a different aspect of the Federal Governments financial condition. The first element of the Statement would be confined to a narrow statement of assets and liabilities limited to those that would be incorporated in a corporate balance sheet. The second (augmented) element would supplement this with long run projections that reflect the full range of future Federal revenue sources and obligations. It would thus reflect the "special" nature of the public sector by recognising sovereign taxation powers and long term spending obligations. The third element would augment the Statement by indicating what the public has obtained by way of national wealth as a result of investments in physical capital infrastructure, education and R&D.

Finally information necessary to address concerns in respect of detering fraud waste and abuse are envisaged as being in the nature of audit certificates which verify management's assertions about the effectiveness of internal accounting and operating control systems.

## APPENDIX 1. A BALANCE SHEET PRESENTATION FOR THE FEDERAL GOVERNMENT

ASSETS/ RESOURCES		LIABILITIES/ RESPONSIBILITIES
<b>Federal Assets</b>		<b>Federal Liabilities</b>
Financial Assets		Financial Liabilities
Gold and Foreign Exchange		Currency and Bank Reserves
Other Monetary Assets		Debt held by the Public
Mortgages and Other Loans	Federal	Miscellaneous
Less Expected Loan Losses	Government	Insurance Liabilities
Other Financial Assets	Assets	Deposit Insurance
	and Liabilities	Pension Benefit Guarantees
		Loan Guarantees
		Other Insurance
		Federal Pension Liabilities
Physical Assets		
Fixed Reproducible Capital		Net Balance
Defence		
Non-defence		
Inventories		
Non-reproducible Capital		
Land		
Mineral Rights		
<b>Resource/Receipts</b>		<b>Responsibilities/Outlays</b>
Project Receipts	Federal	Discretionary Outlays
	Government	Mandatory Outlays
Addendum:	Resources &	Social Security
Real GDP	Responsibilities:	Medical Programmes
	Budget	Other Programmes
	Projections	Net Interest
		Deficit
<b>National Assets/Resources</b>		<b>National Needs/Conditions</b>
Federal Owned Physical Assets	National	Indicators of Economic, social
State & Local Physical Assets	Wealth and	educational, and environmental
Federal Contribution	Well-being	well-being to be used as a
Privately Owned Physical Assets		scorecard of current conditions
Education Capital		
Federal Contribution		
R&D Capital		
Federal Contribution		

**Source:** Appendix One, Section E, "Budget Baselines, Historical Data and Alternatives for the Future"  
USA January 1993.

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