

30 May 2001

Dr Margot Kerley
Secretary
Joint Committee of Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Dr Kerley

REVIEW OF THE ACCRUAL BUDGET DOCUMENTATION

I refer to your letter of 3 April 2001 in which you invited a submission from the Australian National Audit Office on a review of the accrual budget documentation being conducted by the Joint Committee of Public Accounts and Audit.

I enclose our submission for the Committee. If the Committee has any further queries, please do not hesitate to contact Ms Lynne O'Brien (phone 6203 7572).

Yours sincerely

Ian McPhee
Deputy Auditor-General

Introduction

The first accrual budget was presented to Federal Parliament in May 1999 covering the 1999-2000 financial year. The accrual budgeting reforms changed substantially the way in which budget documentation, including the Portfolio Budget Statements (PBS), Annual Reports and the Portfolio Additional Estimates, is constructed and reported to Parliament. Notwithstanding these changes, the objectives of such documentation has not changed. That is, the budget documentation should enable Parliamentarians to understand the economic and financial outlook, the composition of the budget including new budget measures, and expected outputs and outcomes and performance measures for the budget year.

One of the key challenges with the form of budget documentation over the years has been how to maintain consistency in concepts, formats and trends in the face of change, while succinctly conveying to the Parliament the outputs and outcomes expected from the budget both in terms of revenue and anticipated expenses to be funded from standing and annual appropriations.

The Department of Finance and Administration (Finance) has refined the format of the PBS over time in light of the adoption of accrual budgeting and feedback from Parliament and its Committees on how Parliament's interests might be better served. This is an area where continuous improvement is to be expected given the evolving nature of the public sector reforms and program administration. However, it is timely for the Committee to review whether further steps can be taken given the key nature of these documents in supporting the Government's budget proposals.

The Australian National Audit Office (ANAO) recognises that there are considerable advantages in the Commonwealth's accrual budgeting reforms while appreciating the implementation of the concepts will take time to bed down. In this context, the ANAO has previously provided the JCPAA its views on the impact of accrual budgeting on the quality and accessibility of information to the Parliament¹ (copy attached). However, the ANAO agrees with the conclusions of two previous reports of the Senate Finance and Public Administration Legislative (F&PAL) Committee² into the form of the PBS, that there are a number of areas in which budget documentation and disclosure could be enhanced to increase its contribution to public sector accountability and to facilitate its use by Parliamentarians. In particular, the Committee's 1999 report noted that Senators wanted:

- less aggregated financial information;
- more standardisation across PBS; and
- forward estimates for outcomes and outputs.

¹ Australian National Audit Office, Submission to Joint Committee of Public Accounts and Audit, *The Impact of Accrual Budgeting on the Parliament*, 6 June 2000

² The Parliament of the Commonwealth of Australia, Senate Finance and Public Administration Legislation Committee, *The Format of Portfolio Budget Statements, Second Report*, October 1999 and *Third Report*, November 2000

In its 2000 report, the F&PAL Committee commented that Senators were seeking greater consistency and comparability of the pricing and performance information contained in the PBS. The Committee sought the provision of forward estimates information and, in response to concerns about the time lapse between the setting of indicators and reporting against them, suggested that agencies provide part-year performance in the PBS where available. The Committee also noted that inadequate reporting on progress towards outcomes was a weakness of the new system.

A number of suggestions are presented in this Submission to advance consideration of the issues raised in these earlier reviews. In particular, the ANAO considers that there are three broad areas that should be addressed in seeking to improve current practices as follows:

- ascertaining the information necessary, and how it should be presented, to allow Parliament to reach an informed decision on the budget proposals, including the annual appropriation bills;
- refining performance information, particularly relating to program effectiveness measures and the contribution of outputs to intermediate and final outcomes; and
- enhancing the usefulness of financial reporting, including matters such as disclosure of accounting policies and output costing.

Information and its presentation

The JCPAA has included reviewing the link between the information contained in the PBS and annual reports of agencies as part of its Terms of Reference. In considering the appropriateness of such links, it is necessary for the objectives and purpose of each of the two documents to be clearly defined and understood.

The PBS are presented by Ministers to inform Senators and Members of the proposed allocation of resources to Government outcomes by agencies within the portfolio and to provide performance indicators against which agencies' contributions to these outcomes can be assessed. To a large extent, the document is seen as an explanatory statement supporting the appropriation bills. On these grounds, the Government rejected, as unnecessary, suggestions of the earlier Parliamentary reviews that forward estimates and detailed variation explanations be included within the PBS.

In the ANAO's opinion, the role of the PBS could be usefully expanded to allow budgetary expectations to be readily assessed against past performance where relevant. As the report of the Minister, the PBS could be expanded to report on progress towards planned outcomes which was an area of concern in earlier Parliamentary reviews.

Further, while the budgeted financial statements include aggregated forward estimates, the ANAO considers that the inclusion of such information at an outcome and output level would better allow Parliamentarians to place current year budget requirements in context, given the multi-year nature of government programs and the fact that expected outcomes can normally only be achieved over a period of time.

This, in turn, is likely to encourage a focus on multi-year targets for program performance .

The ANAO sees it as important to agree the scope and coverage of the PBS as a first step. Once this has been considered, presentation issues would then need to be reviewed. One issue in this context is whether some degree of differential reporting should be considered having regard to the materiality (nature or amount) of the particular output or outcome. Obviously, the views of Parliament would bear on such a decision but it has the attraction of encouraging agencies and Parliament to better target their attention and efforts to 'material' programs and expenditures. At a more fundamental level, any expansion of the PBS to cater for the forward estimates for outcomes and outputs would require a review of the current format.

We would expect that the annual report would continue to be focused on the operations of the agency in delivering outputs, both retrospectively (for example, through inclusion and discussion of financial statements and output performance information) and prospectively (for example, through information corporate governance arrangements and future directions).

Performance information

ANAO audit activity

Since the introduction of program management and budgeting, the development of appropriate performance indicators has been a continuing challenge for Commonwealth entities. Given this requirement, it has and continues to receive ANAO attention³. One of the key themes identified for performance audits programmed by the ANAO for 2000-2001 is performance information as it relates to corporate governance. While the validity and reliability of performance information is a key consideration in most ANAO performance audits, two audits specifically considering performance information within PBS are currently underway.

The first, an audit of the Australian Taxation Office, is examining performance reporting within the outputs and outcomes framework to identify areas for improvement in specifying, measuring, administering and reporting outputs and outcomes. This audit is scheduled for tabling in June 2001.

In the second audit, the ANAO is examining the appropriateness of performance information in PBS across a selection of ten Commonwealth bodies⁴. This audit is scheduled for tabling in September/October 2001.

³ See for example, Audit Report No. 25 1995-96, *Performance Information*, Department of Employment, Education, Training and Youth Affairs and *Performance Information Principles*, Better Practice Guide, Australian National Audit Office and Department of Finance, November 1996

⁴ Government organisations included within this audit are the Department of Defence, the Department of Education, Training and Youth Affairs, the Australian National Training Authority, the Department of Employment, Workplace Relations and Small Business, the National Occupational Health and Safety Commission, the Department of Family and Communication Services, the Department of Industry, Science and Resources, the Australian Geological Survey Organisation, the Department of Transport and Regional Services and the Australian Maritime Safety Authority.

In these audits, the ANAO is examining matters such as:

- outcomes, outputs, strategies and whether relationships between these are sufficiently evident in the annual reports;
- whether there is appropriate explanatory and statistical information supporting performance information reporting; and
- the achievement of outputs and outcomes and whether their relationship with agency strategies is sufficiently evident and any necessary remedial action and/or ameliorating factors identified to make the reporting more useful.

There are a number of themes emerging from these audits of relevance to the current JCPAA inquiry including:

- processes for collecting and collating performance information;
- the regularity of performance reporting and the use of such reports for management purposes;
- the link between an organisation's outcomes, outputs and the associated strategies;
- the defining of targets; and
- the disclosure of actual results within annual reports.

These audits have confirmed that agencies are experiencing difficulties in establishing and demonstrating links between desired outcomes and the outputs to be delivered by the agency as well as in identifying performance indicators which can be used to measure and monitor success in delivering outputs and achieving outcomes. In part, the use of very broadly defined or 'aspirational' outcomes by agencies has contributed to this situation. The ANAO considers that the use of intermediate outcomes by agencies, as has been encouraged by Finance, will allow improved linking between outcomes and outputs and thus support increased accountability and enhanced outcome reporting over time.

In undertaking these audits on performance information, the ANAO is developing a number of principles of better practice in relation to specifying performance measures, and to measuring and reporting performance. The audits will provide material for the preparation of a better practice guide for performance information in PBS and annual reports. The better practice guide is scheduled for publication in April 2002.

Measures used to assess performance in achieving government outcomes

In a paper presented to a 1999 accounting conference⁵, Mr Andrew Podger, the Secretary of the Department of Health and Aged Care, stated that:

⁵ S Podger, *Comments on Professor Guthrie's 1999 Annual Research Lecture in Government Accounting*, CPA Australia, Australian Experience with Accrual Output Based Budgeting : When Theory and Practice Don't Meet, page 21.

There is ... a genuine risk that accrual budgeting will focus more on departmental outputs and less on program outcomes and thus direct attention away from the over 95 percent of outlays on programs to the less than 5 per cent on running costs.

The earlier Parliamentary reviews commented on the difficulty of measuring and assessing performance in achieving government outcomes and the difficulty in obtaining an understanding of cross portfolio contributions to the same outcome⁶. This has always been a challenge, made even more difficult due to the high level of aggregation for some outcomes.

As suggested earlier, in the ANAO's opinion there could be an enhanced role for the reporting of outcomes within the PBS. As an example, for outcomes to which a portfolio agency makes a major contribution, such reporting could address:

- progress achieved towards outcomes, including whether planned intermediate outcomes had been met;
- the actions taken by the agency to influence the actions of such other parties, where applicable; and
- expected outcomes in the budget and forward years.

Such reporting should not be seen to imply an increased accountability of agencies for outcomes. Arguably such accountability has always applied, with Secretaries being accountable for the actions taken by the agency to achieve the Government's planned outcomes. Given the political nature of Government and the multi-faceted dimensions of its activities, relevant measures of performance require careful consideration and should reflect separate agency and others' responsibilities to the extent that this is practicable. This enhanced reporting would assist in addressing the concerns noted by Mr Podger above, by refocussing attention particularly on outcomes.

It will also address concerns, noted by the earlier inquiries, in relation to the lack of cross-portfolio information on outcomes. That is, the reporting against outcomes would be conducted by a portfolio agency with the most significant role in relation to that outcome, and that agency would include in its report how other parties, including other government entities, had contributed towards the achievement of the outcome. For example, the outcomes in relation to the Government's regional Australia agenda could be reported within the Department of Transport and Regional Australia's PBS.

Disclosure of accounting policies and output costs

Explanation of departures from accounting standards

To enable Parliamentarians to make comparisons between budgeted and actual financial performance of agencies, it is important that consistent accounting policies are adopted in the preparation of financial statements. Without such consistency, each budget to actual variation would need to be assessed to determine whether it resulted

⁶ Ibid. page 11

from a change of accounting policy or from a variation in planned financial performance⁷. Compliance with accounting standards is fundamental in ensuring such consistency.

Where accounting standards are not complied with in preparation of actual financial statements, that departure will generally be discussed in the financial statements and, if material, will be included in a qualification to the audit report.

In the budget context, the Charter of Budget Honestly requires that the Budget Economic and Fiscal Outlook Report be based on external reporting standards and identify, in general terms, the external reporting standards on which it is based and any way in which the Report departs from these standards. For this purpose, 'external reporting standards' are defined to include the concepts and classifications set out in GFS Australia as well as public sector accounting standards issued by the Public Sector Accounting Standards Board⁸. Implicit within this provision is that agencies would be required to meet the same standards in preparing the PBS.

The 2000-2001 budget, *Budget Paper No. 1*⁹ included a discussion of external reporting standards and the fact that the accounting policies adopted in the budget had departed from relevant accounting standards in relation to non-recognition of GST revenue. The budget papers noted that Australian Accounting Standard 31 *Financial Reporting by Governments* (AAS31) and other relevant accounting standards would suggest the gross amount of GST be included in the Commonwealth's Financial Statements. However, because the intent of the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* that GST is a State tax collected by the Commonwealth in an agency capacity, GST revenues and associated payments to the States and Territories were not recorded in the Budget financial statements. This matter is further discussed in the PBS of the Australian Taxation Office¹⁰ and the Department of Treasury¹¹ where the distribution of GST revenue to the States is disclosed as negative revenue.

⁷ In a recent speech to the Wellington Region Chamber of Commerce, the New Zealand Minister of Finance, Dr Michael Cullen described the purpose of budget information as providing a basis on which the public can evaluate the Government's management of its resources. Dr Cullen highlighted the importance of budget analysis in assisting the public in understanding stewardship performance and discussed the fact that, taken alone, financial reports may not provide an accurate reflection of stewardship performance as financial results can be influenced significantly by accounting policy changes and valuation adjustments that may flow from "highly technical and inherently subjective assumptions". He highlighted the importance of developing supplementary indicators so that the financial results "do not lead to ideological bias in decision making, or sub-optimal financing". Michael Cullen, 2001, *Speech to Wellington Regional Chamber of Commerce*, 3 May

⁸ As a result of new accounting standard setting arrangements established by the Government under the Corporate Law Economic Reform Program, the Public Sector Accounting Standards Board was abolished and has been replaced by an Australian Accounting Standards Board. The new Board is responsible for making accounting standards for the private, public and non-profit sectors.

⁹ The Commonwealth of Australia, 2000, *Budget Strategy and Outlook 2000-01, Budget Paper No. 1*, pages 4-11 and 4-12

¹⁰ *ibid*, page 165

¹¹ The Commonwealth of Australia, 2000, *Portfolio Budget Statements 2000-01, Treasury Portfolio, Budget Related Paper No. 1.16*, page 38.

While agencies will sometimes check with the ANAO as to whether a particular accounting policy adopted in preparation of budget documentation is in accordance with accounting standards, this is done on an ad hoc, rather than on a systematic ongoing basis. Consequently, the ANAO advice may, or may not, be reflected in the final budgeted financial statements.

The current budget system relies on agencies to identify and disclose where there has been a departure from accounting standards. There is no independent confirmation of this process. Given the ANAO will need to form an opinion on the same accounting policies in the context of audits of actual financial statements, it would be better practice for agencies to consult with the ANAO on the accounting policies in respect of new or complex financial arrangements at the time of budget preparation.

It should be mentioned in this context that the ANAO has a continuing dialogue with Finance on accounting issues as the new framework settles down. One area of ongoing discussion has been the capital usage charge which, with the introduction of accrual budgeting, was imposed upon the “departmental¹²” net assets of budget funded agencies. During implementation of accrual budgeting, agencies were funded for the capital usage charge by way of appropriation from the Government. The charge is imposed on the net assets of the agency at the end of the year and is required to be disclosed as a ‘below the line’ adjustment on operating statements. That is, the charge is effectively treated as a dividend to the Commonwealth.

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

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

¹² Departmental assets are those the agency controls on its own behalf. They can be distinguished from ‘administered’ assets which are assets an agency administers on behalf of the Government.

Output costing/pricing

The ANAO considers that a fundamental component of the accrual budgeting framework is that appropriations be disaggregated to the output level within the PBS. The same point was recommended by the F & PAL Committee. Unless the PBS disclose the cost/price of such outputs, Parliament is not in a position to make an informed decision on which outputs should be 'purchased'.

While the budgetary model has been clearly enunciated, not all agencies have implemented systems and processes necessary to cost accurately and measure the delivery of all outputs. It can be difficult to define precisely what outputs have been delivered and at what cost or price. Accordingly, financial reporting practices currently adopted effectively assume the complete delivery of outputs by agencies. While information on output delivery is disclosed in annual reports of agencies at this time, appropriation funding flows to agencies are generally not tightly linked to the delivery of outputs. This approach reflects the current budgetary framework and method of accounting for parliamentary appropriations and, in our view, is appropriate given the current state of development of performance information in agencies.

On a related matter the current ANAO audit of performance information within agencies has indicated widely ranging practice with some agencies collecting performance information only on an annual basis and conducting little quality control over that information, instead of relying on the operational areas to provide accurate data. Conversely, better practice organisations are utilising techniques such as monthly updates of intranet based records for collecting and monitoring performance information, and for executive reporting.

These issues are reflective of the fact that the outcomes and outputs framework and the model of government as customer and government as owner, is still in its developmental phase.

Conclusion

Accrual budgeting serves to highlight fundamental performance and accountability requirements with the discharge of Commonwealth public expenditure. There are emerging issues in these areas. Given the significance of Government expenditure which is directed materially at program levels, with the fundamental emphasis on outcomes, there is clearly more work required with definition and alignment of outcomes and related measurement processes – both at a departmental and whole-of-government level. These are considered to be of primary importance in a robust accrual budget documentation process.

It is evident from the earlier Parliamentary inquiries, that the current budget documentation is not meeting the needs of all Parliamentarians. To some extent, this may be a reflection of the complexity of the new framework and the time necessarily taken for Parliamentarians to become familiar with the construct and content of the revised budget documentation. Nevertheless, in the ANAO's opinion, this situation could be improved by enhancing budget documentation, most notably by:

- expanding the role of the PBS to include reporting on progress achieved towards outcomes by those agencies with a significant responsibility in relation to particular government outcomes;
- providing additional outyear information within the PBS so that Parliamentarians are able to place current year budget requirements and targets within context;
- improving the underlying linkages between and pricing of outcomes, outputs and strategies so as to facilitate understanding of this information by Parliamentarians; and
- encouraging agencies to consult with the ANAO on accounting policies in respect of new or complex financial arrangements at the time of budget preparation.

Following agreement as to the scope and content of budget documentation, presentation issues could then be considered with the aim of making the documentation more user-friendly.