

Joint Committee of Public Accounts and Audit
“Review of the Accrual Budget Documentation”

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The accrual budget documentation currently provided to Parliament is exceedingly complex, detailed and difficult to understand. Its usefulness would be assisted materially if it were simplified and made to be more understandable by major users (parliamentarians, public servants, external analysts, and interested members of the public). This is not to be taken as a criticism of the results achieved by the principal departments responsible for budget preparation (Treasury and DOFA); rather they are to be commended for producing an enormous array of financial information and in this they lead the world. However there is scope to refine and simplify the information provided now that several years of experience with accrual budgeting has been achieved.

The Commonwealth budget is necessarily a complex document and I do not understand everything in it. Similarly, I am not familiar with many of the administrative procedures adopted in the Australian Public Service (APS). My experience is that of a teacher and researcher working on public sector financial management issues, based on my academic background in economics, accounting and finance, and supplemented by 12 years as a Pro Vice Chancellor at the Australian National University in charge of physical and financial resource management and financial management information systems. I apologise for any errors of fact or interpretation in my submission because of my lack of detailed knowledge of the public sector.

This submission only covers some of the fundamental principles and issues which underlie the presentation of budget information to parliament.

1. Purpose of financial statements, including budget reports.

The purpose of financial statements and the information contained in them is to assist the government and parliament to formulate policies involving the use of resources to

enhance the good of the nation, to facilitate management control of the resources and of the financial position of the government, to facilitate the measurement of achieved performance, and to facilitate accountability of the government for its activities. Financial statements are the end product of a financial management information system (FMIS). A good FMIS should satisfy the criteria of relevance to the end purpose, reliability, understandability by informed users, and comparability of information (Statement of Accounting Concepts No. 3, 1990). As such, ex ante budgeted financial reports must be user-friendly to parliamentarians so that they can competently exercise their functions in the governance of the nation. Governments and parliamentarians are accountable to the electorate for their policies and performance in a democratic nation. Moreover, the electorate must be kept well-informed of government activities so that it can make informed choices at election time.

The relevance of information depends on the purposes it is to serve. In turn, this depends upon the role of government in a modern, democratic society.

2. Roles of government

The roles of government have become a controversial matter in recent years with the development of public choice theory which advocates a substantial curtailment of roles pursued since the 1930's (Buchanan and Musgrave, 1999; Commonwealth Commission of Audit, 1996). The traditional roles, which were heavily influenced by the experience of the Great Depression of 1929-33 and Keynesian economics, comprise (Musgrave, 1988; Stiglitz, 1988; Barton, 1997):

- i. Provision of government or "public goods" to the nation, ie. those goods whose use is largely non-rival and non-excludable and are more efficiently provided by government than by the private sector, eg. defence, law and order, public roads, and broadcasting. Governments provide "... goods and services outside the normal market mechanism for consumption by governments and the general public. Costs of production are mainly financed from public tax revenues. Goods or services are provided free of charge or at nominal charges well below costs of production" (Commonwealth of Australia, 1999, p.26).
- ii. Social justice programs to bring about a more equitable distribution of income and wealth in society than that which results from free market forces, and greater

equality of opportunity, eg. transfer payments and provision of public health, education and housing facilities.

- iii. Macroeconomic management of the economy to bring about sustained economic growth and full employment without significant inflation.
- iv. Intergenerational equity to ensure that each generation pays for the public services and social justice programs from which it benefits, and maintains the nation's environmental and cultural resources, and thereby does not bequeath substantial debts and an eroded environmental and cultural environment to future generations.
- v. Efficient and effective management of government resources so as to minimise the cost of providing public services. Inefficient use of resources means that some resources are being wasted.

The newer public choice theory on the role of government focuses on the provision of public goods and efficiency in the use resources, with less emphasis being devoted to the other roles.

3. Relevant information for each of the above roles of government

These are spelt out in Barton (1997) and are as follows:

- i. Provision of government goods and services
With respect to the budget, the relevant measure comprises the cash expenditures on the goods and services to be provided over the year. Cash expenditures measure the additional resources devoted to the provision of these goods and services to the public over the year. But for efficient management of the total stock of resources used by government to provide these goods and services, and to measure the total government cost of providing these goods and services, accrual accounting information is required – this is covered in v) below.
- ii. Social justice programs
Again, cash expenditures are relevant for measuring the government's provision of transfer payments and for provision of public health, education and housing

services over the year. Taxation revenue, and particularly information on the progressivity of the tax system, are also relevant for social justice policies. As with i), accrual accounting information is required to measure the total costs of providing public facilities and for efficient management of resources used by public hospitals etc.

iii. Macroeconomic management of the economy

Cash receipts and payments are relevant for formulation of macroeconomic policies. Cash receipts from taxation and other charges measure the withdrawal of resources from the private sector for use by the government; cash expenditures (excluding transfer payments) measure the government's contribution to economic activity over the year and hence to the GDP. The resulting budget surplus/deficit measures the contractionary/expansionary effect of government activities for the year, and is an important guide for macroeconomic stabilisation policies. Both the composition of expenditures (on social justice, public health, defence, etc. and on physical and social infrastructure) and of taxation revenue, and the size of government expenditures and of the budget surplus/deficit are relevant for macroeconomic policy formulation.

iv. Maintenance of intergenerational equity

Lifespan cash budgets of receipts and payments covering say 80 years are required to assess whether each generation is funding the provision of publicly financed government services to it and maintaining intact the nation's stock of capital (including productive, environmental and cultural resources). Such budgets lie outside the province of those reported annually to parliament and are needed for very long term policy formulation.

For assessment of intergenerational equity policies over the next few years, accrual financial statements which measure the government's financial position (stock of assets and liabilities and capital maintenance) and full costs of providing government services (including capital consumption charges and unfunded superannuation expenses), are needed. Government revenues should cover the full costs of providing government services over the economic cycle. The accrual budget balance measures the extent to which revenues cover the full costs of service provision each year. An accrual budget deficit indicates that the

current generation is not contributing sufficiently to cover the full cost of services provided and hence leaving a deficit to be funded by citizens in later years; and conversely for an accrual budget surplus.

v. Efficient and effective management of government resources

The efficient and effective management of government resources used to provide those public goods and services approved by parliament is a matter of microeconomic management. The responsibility for this rests primarily at the departmental and program levels, though parliament would wish to know that government resources are being used efficiently and effectively. This should be accomplished through the provision of departmental annual reports to parliament which include full accrual budgeted and expost financial statements. The efficient use of resources including the department's capital stock requires the use of accrual accounting so that total costs of operations are measured and related to the department's revenue (mainly government grants). Capital consumption charges (depreciation and amortisation of fixed assets) and unfunded employee entitlements (particularly superannuation) must be included in the measurement of operating costs.

But in addition to their physical assets, governments have enormous cash flows. Commonwealth revenues approximate \$160 billion pa and expenditures similarly; as well there is a substantial turnover of debt instruments (treasury bills and bonds) each year. Cash basis accounting information systems must be maintained to provide the appropriate information for efficient cash management. This information is required on a daily basis. Preparation of cash flow statements by working back from accrual accounting reports cannot be done for this purpose – these statements cannot be prepared until several months after the end of the financial year.

Summary of Financial Information Requirements

By examining the roles of government, it can be seen that financial information from both cash and accrual accounting systems is required. Cash budget information is required for the provision of public goods and services, social welfare programs, macroeconomic management, long term intergenerational equity and cash management policies. Apart from the last use, parliament and governments requires cash budget information for policy formulation. However the efficient management of total resources (including all assets and all liabilities) and measurement of full costs of providing government goods and services requires full accrual accounting information.

This function occurs at the departmental and program levels and is mainly concerned with the provision of public goods and services according to the prescriptions of government policy. Management of cash resources requires the daily preparation of cash flow budgets and for this, a cash accounting system is required.

Fortunately, cash accounting and accrual accounting systems can co-exist if cash accounting is viewed as a subset of the more comprehensive full accrual accounting systems. The accrual accounting system can be designed to capture all cash transactions in a cash flow statement. Unfortunately most accounting systems are not designed in this way and cash flow statements can only be prepared by working back through the accrual accounting statements to remove the cash items from them. Most accounting systems are designed around the concept of an asset and adopt the “balance sheet approach”, as advocated by professional accounting standards. Unfortunately, DOFA adopted this approach and discontinued its cash accounting system with the adoption of full accrual accounting.

4. Legal Responsibility of Parliament and Government for Financial Accountability and Control of Public Monies and Public Property

These are based on the Commonwealth Constitution, 1901, and the Financial Management and Accountability Act, 1997 (FMA). Sn 83 of the Constitution requires that all expenditures be approved by Parliament; Sn 81 requires that all money raised must be deposited in the Consolidated Revenue Fund; and Sn 83 requires that all expenditures are approved by Parliament in the form of Appropriation Acts, (Funnell and Cooper, 1998, page 52). These constitutional requirements set the framework for the government’s budget each year. Thus, the whole budgetary process is driven by the expenditure of cash and the need to raise the cash required to fund approved expenditures. The FMA Act 1997 provides the framework for the proper management of public money and public property. Public money is defined as money in the custody or under the control of the Commonwealth or an authorised officer of the Commonwealth; and public property is similarly defined (Sn 5).

These requirements are integral to the accountability responsibilities of the Government and Ministers, Parliament, and public service officers. Accountability means there is an obligation to disclose, explain and justify decisions, policies and actions taken by government acting on behalf of the electorate. It requires that Parliament and the public be kept informed of government decisions, policies and actions and their results.

Accountability comprises both fiduciary considerations, ie. probity and legality of all cash raising and expenditure, and management efficiency and effectiveness over the use of all resources. Transparency of policy making and actions, and accountability for them, are fundamental to the democratic process and the Westminster System of government.

Again, both cash flow and accrual financial statements are required to satisfy these legal responsibilities. The proper management of public money requires use of cash flow statements while the proper management of public property requires the use of accrual financial statements. Ex ante budget reports are required for policy making and ex post historical statements are required for reporting on actions taken and performance measurement.

I question whether the provision of accrual budgets alone, in which the cash flow information is obfuscated and not transparent, adequately satisfies legal requirements. Furthermore, the linkage between the accrual annual budget statements and their related cash appropriation bills is not transparent. These limitations of the present accrual budgeting format make it difficult for parliamentarians to exercise properly their decision making and accountability responsibilities. Much of the information in the accrual budgets (eg. depreciation and amortisation charges on fixed assets, revaluation adjustments etc) is not relevant for the proper control of public money and accountability responsibility for their use. The solution to this predicament is to provide Parliament with both cash and accrual budgets. While it might be argued that this would create confusion, the differences between the two are readily explained and understandable. Moreover, this confusion problem would be trivial in comparison with the current provision of two sets of accrual budgets which report vastly different results. This matter is considered below in Section 6.

5. Application of Business Accounting Standards to the Public Sector

The Accounting Standards Board argues that professional accounting principles initially developed for business enterprises should, with only minor amendment, be applied to the public sector of the economy. These principles are incorporated in the major public sector standards:

AAS27, Financial Reporting by Local Governments (1997),

AAS29, Financial Reporting by Government Departments (1996),

AAS31, Financial Reporting by Governments (1996),

SAC1, Definition of the Reporting Entity (1990),

SAC2, Objectives of General Purpose Financial Reports (1990),

SAC4, Definition and Recognition of Elements of Financial Statements (1992)

The Board believes that the financial information needs of public sector management and the assets used are fundamentally similar to those of business management, and hence that the same set of accounting principles and types of financial statements are applicable to both sectors (McGregor, 1999). The accrual budget statements presented in Budget Statement 10, and the ex post financial statements of the Government and its departments, are based on AAS29 and AAS31.

I dispute the relevance of business accounting principles and standards for major parts of the public sector (Barton, 1999). Given the wide range of roles by government, no one set of accounting principles and standards is suitable for the entire sector. Governments provide a wide range of public goods and social welfare benefits to the community which differ fundamentally from private goods provided by business firms. These goods are provided freely to the community or at nominal charges only, and funded mainly from taxation revenue. The markets for these public goods and services differ fundamentally to those for private goods provided by business firms (Musgrave, 1988, chapters 1 and 4; Stiglitz, 1988, chapters 1, 3 and 5; Barton, 1999). The Accounting Standards Board seems to be unaware of the nature of these public goods markets and their accounting principles do not fit readily into this different market environment.

Business firms operate in markets where customers obtain property rights to the goods they purchase and where consumption is rival and excludable. They must charge prices covering full cost and earn profits sufficient to attract and retain investment funds, otherwise they fail. They must maintain a sound financial position to remain solvent. These conditions do not apply to many public sector markets. Business accounting systems have been developed to provide firms with appropriate financial information to enable firms to function effectively, and as a consequence of competitive market systems, successful firms are forced to operate efficiently in their use of resources.

While much can be learned from an analysis of business accounting principles to develop accrual accounting standards for use in parts of the public sector; the standards must be adapted to suit the different market environment. Accrual accounting

appropriately adapted can be very useful in general government administration to facilitate the efficient use of government resources and for asset and liability management (Barton, 2000b). Lack of information on non-financial resources and on liabilities, which prevented their efficient management and the full costing of government departments and programs, was a major deficiency in the former cash accounting systems used by government. However, major accounting issues of a different nature are raised in accounting for the unique areas of the public sector environment such as defence, protection/enhancement of environmental and cultural resources, and provision of many community facilities such as parklands. Existing accounting standards should not be applied to them. As well, existing accounting standards do not suit many infrastructure industries, such as water, sewerage and drainage systems, and road networks. These problem areas require a major rethink on their accounting information requirements (Carnegie and Wolnizer 1995, Barton2000a).

A basic problem with the existing accounting standards arises from them being built around a defective concept of an “asset”. In SAC4 (para 14), assets are defined as “future economic benefits controlled by the entity as a result of past transactions or other events”. But assets are not “future economic benefits” – rather they are the resources used to produce such benefits. Economic benefits are cash or cash equivalent benefits. Secondly, many government assets are dedicated to the provision of non-cash social or defence benefits to the community at large and not to the government itself, eg. defence, law and order, public art galleries and museums, national parks, roads and so on. These resources do not comply with the definition, although the Board maintains they do. All the other definitions of basic concepts (revenue, expense, liabilities and capital) are based on this defective asset definition. Furthermore, the standards are based on the “balance sheet” approach to accounting. A “transactions flow” approach is simpler and more versatile, and it facilitates the preparation of a wide range of financial management reports, including cash flow statements along with operating statements and balance sheets (Barton, 1984).

As explained above in Section 3, accrual budget information is only of limited relevance to Parliament for policy making; cash budget information is much more relevant for the major policy making roles of government and for cash management. Accrual budget information is relevant primarily at the departmental/program resource management levels of government operations. Its inclusion in the annual budgets for

policy making decisions by government and parliament is not particularly helpful because much of the information is not relevant for this purpose.

Provision of Two Sets of Accrual Budgets

The accrual budget environment is made unnecessarily complex and confusing by the provision of two distinct sets of accrual budgets showing very different results for the coming year. This raises the question in the minds of non-accountants as to which one is correct. Accountants are familiar with the range of accounting options available!

Budget Statement 9 is prepared in accordance with the ABS accrual Government Finance Statistics (GFS) framework, and is designed to support economic analysis of government activities. Budget Statement 10 is prepared on an accrual basis in accordance with AAS31, and is prepared on the basis of the Commonwealth Government being a giant business corporation.

The provision of two sets of accrual budgets reporting significantly different results causes confusion and lack of transparency. The adjustments required to move from one set of budgets to the other are complex and not straightforward as are those required to reconcile cash and accrual financial statements. The following tabulation highlights the differences in component totals in each set of budgets for 2001-02.

	Budget Paper 9 GFS \$ m	Budget Paper 10 AAS31 \$ m	Difference \$ m
Total revenue	186,320	161,613	24,707
Total expenses	188,355	163,559	24,796
Operating Result (S/D)	- 2,035	- 1,946	89
Fin'l Assets	100,782	54,513	46,269
Non Fin'l Assets	30,686	61,429	- 30,743
Total Assets	131,468	115,942	15,526
Total Liabilities	165,383	166,216	- 833
Equity	- 33,915	- 50,274	- 16,359

Fortunately, the cash balance in each set of statements is identical!

The two sets of budget statements are reconciled in Budget Statement 11, Table 2.

The presentation of two sets of statements also raises an interesting audit question as to which set provides a true and fair view of the financial position of the Commonwealth Government and the results of its operations for the year.

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