

ACCRUAL ACCOUNTING AND BUDGETING SYSTEMS ISSUES IN AUSTRALIAN GOVERNMENTS

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Abstract

Much confusion has resulted from the adoption of two accrual accounting and budgeting systems by Australian Governments – the Government Finance Statistics system and the Australian Accounting Standards system – as each reports vastly different results. Which set of results should be believed and approved by parliament? As well termination of the former Cash Accounting System has deprived governments of important information. The several systems are examined here, and use of an enhanced GFS system, which incorporates the cash system, is recommended.

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The adoption of accrual accounting and budgeting systems (AABS) by Australian governments has been central to the extensive management reform programs adopted over the past twenty years (Department of Finance 1994 a,b; Joint Committee of Public Accounts 1995 a,b; National Commission of Audit 1996). The reforms were widely praised in official publications and promised significant improvements in efficiency of resource management and in enhanced transparency of information and accountability to parliament and the public. But while major improvements have been made in these matters, significant concerns remain about the new accounting information systems and they have created some major problems for government. These matters are explained and reviewed in this paper, and solutions to the problems are proposed.

It is contended that the problems have arisen from the scrapping of the former cash accounting and budgeting system (CABS) upon the introduction of accrual budgeting in 1999, and secondly from the simultaneous introduction of two different accrual budgeting systems. CABS provides necessary information for the management of government fiscal policies and cash, and it should be reintroduced, but as an integral subset of an accrual accounting system. The use of two AAB systems providing widely different financial measurements has created confusion and questions about which sets of figures should be accepted and used. The nature of each system – the Government Finance Statistics (GFS) system based on International Monetary Fund (IMF) requirements and the Australian Accounting Standards (AAS) system – is examined and related to government financial information requirements. It is contended that the GFS system is the more appropriate one for government use, being designed specifically for this purpose; whereas the AAS system is not sufficiently relevant for government as it has been designed primarily for business use, and furthermore, it lacks sufficient analytical rigour.

The paper begins with a brief explanation of the nature and roles of government in a modern democratic nation in order to establish their financial information needs, and of the nature and purpose of accounting information systems. An examination is then made of three systems with respect to the appropriateness of each system in the context of government operations and its analytical rigour. The conflicting information produced by the GFS and AAS systems is highlighted. The conclusions then follow to adopt an enhanced GFS system which incorporates cash accounting and reporting and to terminate the AAS system.

The paper is confined to the activities of the general government, i.e. budget, sector of the Australian Government and does not include the activities of public financial corporations and other government enterprises, and secondly to the information published in regular government financial statements. While it does not refer to state and territory governments, (who are also required to use the same two systems) the same principles apply to them and only the descriptive parts need to be amended to take account of their somewhat different activities.

NATURE AND ROLES OF GOVERNMENT

The nature and roles of government determine what information is required from the Financial Management Information and Reporting System (FMIRS). They establish the environment in which the accounting system is to operate and the purposes for which the information is to be used. In turn, these matters determine what and how the information is to be measured and reported.

The nature and roles of government vary from nation to nation and over time. They can raise very important political issues which ultimately must be resolved by the citizens of a democratic nation. US President Abraham Lincoln (1863) pondered on this question many years ago and he concluded that:

“The legitimate object of government is to do for a community of people whatever they need to have done, but cannot do at all, or cannot do so well, for themselves in their individual capacities.”

Governments typically undertake the following roles (Stiglitz, 2000, Chaps 1-4)

- Provision of public goods and services to citizens such as law, order, defence, infrastructure facilities, basic health and education. These are largely collective items characterised by non-rival and non-excludable consumption. All citizens have equal rights to them, and one's use of them does not normally prevent others from using them.
- Provision of social welfare facilities and services to citizens to bring about greater social equity in the nation.
- Macro-economic management of the economy to promote steady and sustainable economic growth, high levels of employment and price stability.
- Pursuit of intergenerational equity to ensure that each generation pays for the services provided by government to it so as not to bequeath debts to future generations.
- Conservation of the nation's heritage and natural environment so as to avoid their degradation and preserve them for future generations.
- Management of government resources and liabilities to ensure their efficient and effective use. Inefficiency wastes resources and leads to higher costs of service provision.

The above activities of government determine its financial management information, and reporting needs. Their FMIRS must be designed to provide them with appropriate information to facilitate these tasks and to report to stakeholders. The first five roles are the concern of government fiscal (or budget) policies. They all involve the raising and expenditure of cash, and significant externalities. Externalities occur where all the costs and benefits are not confined to the parties involved in the transactions. This occurs because consumption benefits and/or costs are shared (as with all public goods), and/or because of differences between private and social costs and benefits. They fit into Lincoln's notion that governments are better able to do these things on a collective basis than are citizens operating in their private capacities. In accordance with the above, the Australian Government (Budget Papers 2005-06, p. 8.8) sees the role of its General Government Sector (GGS) as the provision of "...public services that are mainly non-market in nature, and for the collective consumption of the community, or involve the transfer or redistribution of income. The services are largely funded through taxation and other compulsory levies."

Fiscal policies are formulated for the nation and must be approved by parliament prior to their implementation. The resource and liability management role is primarily a departmental management responsibility. It is a micro-economic responsibility vested in departmental managers implementing government policies as approved by parliament. Their good management is covered by statute, e.g. Financial Management and Accountability Act (FMA) 1997, Audit Act 1997 and the Public Service Act 1999.

ACCOUNTING AS A FINANCIAL MANAGEMENT INFORMATION AND REPORTING SYSTEM (FMIRS)

As indicated above, the purpose of an accounting system is to provide useful financial information. In the context of the public sector, accounting should be regarded as a financial management information and reporting system for the use of government and its management, parliament and the public as the key stakeholders. It should report information which is useful for decision making in the use of resources and for performance measurement, and for accountability purposes (SAC2, 1990 paras43-45).

Information can be useful only if it satisfies certain criteria for usefulness and is appropriate for the environment and roles of the accounting entity. These criteria comprise relevance, reliability, comparability and understandability, and are explained in SAC3 (1990, paragraph 5). Relevant information must relate to the purposes for which it is to be used, i.e. the decisions made, measurement and assessment of financial position and performance, and the fulfilment of accountability obligations. It must be tailored to suit the operating environment of the entity and the concepts being measured to be relevant and timely. Reliable information requires that it can be depended on to represent faithfully the transactions, concepts and results of operations that it purports to represent and do so without bias or undue error. There must be a correspondence between the message that the information conveys and the reality of the entity's operations. Comparable information requires the use of consistent accounting concepts and practices so that like information can be validly compared within and between statements, over time and between entities. Understandability means that users are readily able to comprehend what the information purports to mean. This requires that the presentation of information must not be obfuscated by irrelevant information, non-disclosure of key items, and

inappropriate terminology, classification of items or accounting practices. The first three criteria for useful information are interrelated and they all impact on understandability.

FMIRS can take a variety of forms according to the information required from them. They may encompass cash transactions only (cash based accounting) or all cash and accrual transactions (partial accrual accounting); they may include other accounting events (i.e. non-transactions which affect income and wealth such as asset consumption charges, i.e. full accrual accounting); they may adopt initial transaction prices of assets and liabilities (historic cost accounting) or their current market values (either entry or exit prices – current value accounting systems) as the basis of income and wealth measurement; and they may use the dollar measuring rod as a unit of exchange or as a unit of general purchasing power. Finally, the systems can relate to the past and record actual transactions and events (expost or outcome financial statements), or to expected future transactions and events (exante or budgeted financial statements).

The only financial report which can be prepared in the cash based accounting system is the Cash Flow Statement, and the only asset reported is the cash balance. Two financial statements can be prepared under partial accrual accounting – a cash flow statement and a summary of external transactions (covering both cash and credit items). Full accrual accounting systems are required to measure income and financial position in addition to the cash flow and all external transactions reports. These involve the measurements of all items of revenue and expense, and all assets and liabilities. As well, detailed management reports on segments of operations (products, departments etc) can be prepared in the system.

The broad framework of these systems is outlined in Appendix 1. The information produced in each system differs, and the choice between them depends upon the type of information required. No one system can provide all the financial information possibly required.

THE MAJOR ISSUES AND THEIR SOLUTION

1. Cessation of Cash Accounting and Budgeting Systems (CABS)

CABS have been used by all Australian governments since birth. They have been viewed as an integral component of a democratic system since the seventeenth century in the United Kingdom, and subsequently in other democratic nations. The Department of Finance (1994a, p9) succinctly summarises the role of cash accounting in the Westminster system of government as:

“Historically, governments have operated on an annual cash basis because this is fundamental to the democratic constitutional safeguards which have been evolving since the days of King Charles I of England. The basic safeguard is that no monies shall be collected or spent except in ways and amounts approved by Parliament through budget appropriations”.

These requirements are included in the Australian Constitution 1901 (Section 83) and in the FMA Act 1997. All policies involving cash transactions, both receipts and payments, must first be approved by Parliament prior to implementation. They must also pass through the Consolidated Revenue Fund (CRF) (Section 81). Information on budget compliance must also be submitted to Parliament, and be audited (Audit Act 1997) to certify that Parliament’s wishes have been adhered to. Evidence of budget compliance is an integral part of the accountability process.

Notwithstanding the above requirements, as well as its essential role in fiscal policy determination and cash management, CABS was terminated without public warning upon the introduction of the AAS system of accrual accounting and budgeting in the May 1999 budget. Yet most of the literature supporting the adoption of accrual accounting by government stressed that CABS should be retained as part of the more comprehensive accrual accounting system. For example, the National Commission of Audit (NCA 1996, p223) states:

“Thus, the short to medium term cash impact of the budget will continue to be important for macro-economic management purposes ... accrual budgets would continue to provide this cash information.”

As the preceding explanation of FMIRS and Appendix 1 indicates, there is no technical reason why cash flow reports prepared directly from cash transactions

cannot be prepared daily in an accrual accounting system. Many corporations do so as the information is needed for efficient cash management. In government, it is needed for this purpose but as well for fiscal policy and accountability purposes.

Cash is central to all government fiscal policies because it funds the resources required to provide all the goods and services to the community. Guthrie and Parker (1998, p14) note that "... cash is the resource appropriated from the community by parliament, and cash is the resource used by governments in delivering services to the community". Cash budgets provide parliament with information on the *new resources* required for allocation to departments and programs, and thence to citizens in the form of the types of goods and services discussed above; and secondly, on how they are to be funded through taxation and other measures. Provision of new resources involves government policy decisions and parliamentary approval.

Furthermore, cash is central to macro-economic management of the economy. Governments aim for sustainable and steady economic growth which maintains high levels of employment with low inflation. They can influence these matters both through the massive size of their budgets (currently some \$250,000m of receipts and of expenditures, or ca 23% of GDP for the Australian Government), and the directions of their expenditures and sources of taxation – these affect the allocation of resources in the economy. All transactions affect the level of economic activity – production, sales and employment. All cash transactions involve a *flow of resources* into or out from the government to the community. Expenditures add to aggregate demand in the private sector, while taxation reduces it. The cash budget balance shows the net effect of taxation and expenditure policies on aggregate demand. Budget surpluses reduce it and are contractionary; while budget deficits do the opposite. In turn, this impacts on inflation, economic growth, employment and stability of the economy. The cash budget also impacts on financial markets and interest rates. Deficits must be funded through government borrowing, while surpluses add to the savings of the nation and are available to fund investment expenditure elsewhere.

As well, long term cash budgets extending over the economic cycle are needed to determine whether current policies are compatible with the objective of intergenerational equity. A long term cash deficit indicates that, on current

expectations, taxation receipts are inadequate to fund the budgeted provision of services.

CABS is also necessary for efficient cash management by government to ensure adequate liquidity throughout the year and to minimise borrowing costs. With annual cash operating budget inflows and outflows of about \$250,000m each, the flow of cash through the Government is enormous by business standards. In addition there are significant capital transactions and loan repayments. There can be substantial fluctuations between daily cash inflows and outflows, resulting in daily deficits or surpluses. The Government must ensure it has sufficient cash on hand each day to meet its expenditures, and if a deficit is expected, it must arrange to borrow the money in advance through the sale of treasury notes. Conversely it can invest temporary cash surpluses or redeem outstanding treasury notes. Rolling cash budgets must be prepared each day for efficient cash management.

Hence for fiscal policy purposes, efficient cash management, and budget legal compliance and accountability purposes, CABS is necessary and the information must be available on a timely basis such as daily for cash management. This can be done where the information is compiled directly from cash transactions undertaken each day. The only outcome cash flow statements (CFS) currently published are annual ones which can only satisfy accountability purposes. Unfortunately the statements are prepared from each set of end-of-year accrual financial statements (GFS and AAS) by eliminating all the non-cash transactions and events from them. (Refer to Appendix 1 diagram to see what this involves). This is an inefficient process which takes about 3 months to accomplish.

Furthermore, the cash flow information derived from two different accrual accounting systems using the add-back method can be very different even though they purport to cover the same transactions. Table 1 summarises the cash flows for each major category in the 2005-2006 budgets.

Table 1
GFS and AAS Cash Flow Budgets 2005-06

	GFS \$m	AAS \$m	Difference \$m
Cash receipts from operating accounts	248,506	216,588	31,918
Cash payments for operating accounts	236,308	201,005	35,303
Net CFs from operating accounts	12,198	15,583	-3,385
Net purchase of assets	11,547	14,802	-3,255
Net debt repayment	1,420	1,291	129
Net reduction in cash balance	639m	639m	--

Source: Budget Paper No. 1, 2005-06, Statement 9:6, Statement 10:4

Which sets of figures are to be believed – does the Government expect to receive \$248,506m or \$216,588m in taxes and other receipts, to generate an operating cash surplus of \$12,198m or \$15,583m, etc? Clearly this is an unsatisfactory situation which confuses Parliament and other users and casts doubt on the reliability of the data. The measures selected affect assessment of the macro-economic impact of the budget and financial markets. The differences are caused by the use of different classification criteria in each system. Fortunately the different systems do not affect the final cash balance. The system which reports the more relevant and reliable information for the purpose in hand should be chosen.

Hence, a major reform to the present FMIR systems must be the re-introduction of CABS to enable the regular preparation of CF statements directly from cash transactions. Secondly, it must form a component of the FMIR system judged to be the more appropriate one for the use of government.

2. Adoption of two accrual accounting and budgeting systems (AABS)

The case for the adoption of accrual accounting and budgeting systems is an overwhelming one. Without AABS, the government has no systematic records of its vast holdings of non-cash assets and portfolio of liabilities. As at 30 June, 2004, the General Government Sector of the Australian Government had financial assets of \$71,157m and non-financial assets of \$72,778m (Consolidated Financial Statements

pp82-84, based on AAS). Conversely, it had liabilities for borrowings, staff superannuation and other obligations of \$186,621m. The gross deficit in its net worth was \$77,949m, offset by reserves of \$35,263m (mainly asset revaluation), to yield a negative net equity of \$42,686m. Its assets and liabilities are much larger than those of any Australian business corporation, and furthermore, corporations cannot remain operating with negative equity.

There can be no effective management of such a vast portfolio of assets and liabilities without appropriate accounting records of them. Furthermore, management attention was concentrated on fiscal policy issues, cash budget compliance and cash management, and a refocussing of management attention to encompass all the non-financial assets and liabilities of the Government required “a cultural change” (JCPA 1995a). As a result, many assets were surplus to requirements, under-utilized or poorly maintained (ANAO 1995-96, 1997-98 and 1999-2000). Likewise, burgeoning liabilities from budget deficits and unfunded superannuation commitments were largely ignored. As well, accrual accounting is needed for cost control of departmental operations and of programs for delivery of services to the public. This information is necessary for determining priorities in expenditure programs, and for facilitating better management of government resources and hence efficiency of operations. In brief, accrual accounting is required for the final resource management role of government. But as well, by facilitating greater efficiency in use of the government’s own vast stock of resources, it helps to promote improved macroeconomic management of the economy.

Given the undeniable potential for accrual accounting to yield substantial efficiency benefits, the major issue concerning its adoption is not *whether* it should be adopted, but *which* system of AABS should be adopted. The Government has in fact adopted two very different systems of accrual accounting – the Government Finance Statistics (GFS) standard of the IMF and the system formulated by the Australian Accounting Standards Board (AASB). AAS are the professional accounting standards developed for and used by business. Almost the whole package of AAS and the Statements of Accounting Concepts (SACs) apply to the public sector. However the ones of major relevance comprise AAS29, Financial Reporting by Government Departments (1996), AAS31, Financial Reporting by Government (1996) and the SACs (1990). Table 2

below illustrates the figures produced under each system for the 2005-06 Australian Budget.

Table 2
Comparison of GFS and AAS Accrual Budgets 2005-06

	GFS \$m	AAS \$m	Difference \$m
<u>Operating Statements</u>			
Total Revenues	252,511	217,869	34,642
Total Expenses	243,521	209,074	34,447
Net Operating Results	8,990	8,794	196
<u>Balance Sheets</u>			
Financial Assets	130,507	87,554	42,953
Non-Financial Assets	42,397	75,751	-33,354
Total Assets	172,904	163,305	9,599
Liabilities	198,327	197,885	442
Net Worth	-25,423	-34,579	9,156

Source: Budget Paper No. 1, 2005-06, Statement 9:4 Statement 10:2

Again, as for the cash flow budget figures, the sets of budget figures for each FMIRS are substantially different and the same questions can be asked as to which system portrays the 'true' budget. Again the answer must depend upon which of the systems is more appropriate for the uses of government and provides the more relevant and reliable information. Parliament is dissatisfied with the situation and the Joint Committee of Public Accounts and Audit (2002) held an inquiry into it but was unable to resolve the problem. Subsequently the Financial Reporting Council (FRC) issued a directive to the AASB to 'harmonise' the two systems into a single set of Government reports (18 December 2002). The FRC is a government appointed body which exercises a supervisory role over the activities of the Board. A Heads of Treasury committee has since provided many submissions to facilitate harmonisation for the Board's consideration (Challen & Jeffery, 2003, 2005).

The major differences in the treatment of items are listed in Budget Paper No. 1 2005-06 (Statement 8) and a reconciliation statement is provided. They relate to treatment of the Goods and Services Tax, Commonwealth tax transfers to the States, expenditure on military equipment, valuation bases of assets and liabilities, and holding gains and losses. Their treatment is currently under review for the systems harmonisation project.

The GFS system was introduced in 1993 for the General Government Sector (GGS) for both budget and outcome purposes. However, the statements were not published and it was not applied at the departmental level. It was used by Treasury in conjunction with CABS until 1999, when CABS was discontinued upon the introduction of the AAS accrual budgets. At the same time, the separate recording of cash transactions was abolished with the scrapping of the cash transactions recording system. Also in 1999, the GFS budgets were published for the first time, and in 2000, the outcome statements for GGS.

Accrual accounting based on AAS was introduced progressively by departments from about 1990, and the first departmental outcome statements were produced in 1993. Draft consolidated financial statements for the whole-of-government comprising the GGS and public enterprises were completed in 1995. However CABS budgets and outcome statements were continued till 1999, when AAS budget statements were introduced for both departments and the GGS. Thus since 1999, both AABS budget and outcome statements have been published, though the budgets are for the GGS only and the audited outcome statements are consolidated ones for the whole-of-government only. This in itself is a major anomaly (Challen and Jeffery, 2005), as AAS31 does not recognise the GGS as an accounting entity while the budget does, and there is no budget for the whole-of-government while there are outcome statements for it. The Board recently proposed to rectify this anomaly through the issue of ED142 (August 2005) in which the GGS is to be recognised as an accounting entity. Both sets of AABS are explained and examined below to isolate the causes of the differences between them.

a) Government Finance Statistics – Accrual Accounting and Budgeting System (GFS AABS)

The purpose of the GFS system (IMF 2001, paras 1.2 to 1.4) “is to provide a comprehensive conceptual and accounting framework suitable for analysing and evaluating fiscal policy, especially the performance of the general government sector and the broader public sector of any country”. The system was developed specifically for the public sector to accommodate the special nature and roles of governments and for assessing their economic impact on the nation.

The system is based on IMF economic measurement standards used for the measurement of Gross Domestic Product (GDP) of nations and its components, and is integrated with the UN System of National Accounts (SNA). The system enables relevant and reliable measurements of GDP to be made which are internationally comparable. It is an economic measurement system based on economic concepts throughout and uses a rigorous, analytical approach. It is based on double entry recording, a sharp distinction between stocks and flows of resources, and current market prices of all assets and liabilities (primarily current buying prices of non-financial assets and realisable prices of financial assets and liabilities). The function of the system is to provide governments with information for fiscal policy purposes, as CABS had previously done, rather than for micro management of government activities and resources.

A sharp distinction is made between *stocks* and *flows* of resources in the system because of their differing economic effects. Resource flows directly affect production, sales and employment and enter into the GDP; as well they affect the stocks of resources (i.e. assets, liabilities and net assets or wealth). Changes in resources can also arise from some non-transaction events such as changes in market prices, discovery of new mineral deposits and the growth of forests.

Two types of resource flows are distinguished: transactions and other economic flows. *Transactions* represent resource flows that come about as a result of mutually agreed interactions between the government and external parties. Under accrual accounting, these flows are recognised as and when they occur. Transactions are classified into exchange transactions which involve the purchase and sale of items; and transfers which provide goods, services or cash to or from the government without recognising something in return. Taxes and social welfare benefits are examples of transfer

payments. *Internal asset consumption*, e.g. depreciation of non-financial assets and inventory consumption, is recognised along with transaction resource flows as it reduces resources even though it does not involve a market transaction. These resource flows are summarised in a Statement of Government Operations, and they all impact on the stock of assets and liabilities shown in the balance sheet. (see Appendices 2 and 3). This statement is similar to the Statement of External Transactions portrayed in Appendix 1 but with the inclusion of asset consumption charges. As well, because the system is based on recording transaction resource flows, it is easy to segregate cash transactions and report on them directly in cash flow statements.

Other economic flows represent changes to stocks that do not result from transactions or from internal asset consumption. They arise from price movements and abnormal events. They often arise fortuitously without any active decision making being involved. *Valuation changes* in stocks of resources arise from price changes in individual assets and liabilities. They are holding gains and losses which do not alter the physical stock of resources. All assets and liabilities are revalued at current market prices prevailing at the end of each year, and holding gains and losses are then recognised. *Abnormal items* include damage caused by natural disasters (earthquakes, bushfires, floods, etc), discovery of new mineral resources, and growth of forests etc.. However they are excluded from normal operating resource flows because (for most items) they are irregular and largely unpredictable, and are therefore not amendable to normal macro-economic management policies. The valuation changes and abnormal items are summarised in a Statement of Other Economic Flows (see Appendix 3). They are recorded directly as balance sheet changes and do not enter into the Statement of Government Operations.

Structure of the GFS Analytic Framework

The framework is illustrated in Appendix 3. It shows that the beginning of period stocks in the opening balance sheet, plus transaction resource flows (summarized in the Statement of Government Operations), plus other economic flows (shown in the Statement of Other Economic Flows) yields the end of period balance sheet. This parallels business accounting.

The Statement of Government Operations (Appendices 2 and 3) provides the government with some important economic magnitudes – net operating balance; gross and net capital formation by government; and net lending/borrowing which in turn is represented by the increase in financial assets/liabilities. The net operating balance indicates the ongoing sustainability of government operations. It should be noted that it excludes holding gains and losses on assets/liabilities and other (abnormal) changes in the volume of assets. These items are treated as pure balance sheet items and flow through directly to Net Worth. Net lending/borrowing measures the extent to which the government is either placing resources for disposal by other sectors of the economy or utilizing their savings. It indicates the financial impact of the government on the rest of the economy.

The Statement of Other Economic Flows (Appendix 3) presents the influences on government Net Worth that are not the result of government transactions and asset consumption. Rather, they result from price changes in assets and liabilities (resulting in holding gains and losses) and from special events (natural disasters, new mineral discoveries and so on). These items are recorded directly in Net Worth and do not pass through the Statement of Government Operations.

The closing Balance Sheet presents the stock of assets and liabilities and shows the government's Net Worth. Change in Net Worth helps assess the sustainability of government operations. Declining net worth (consequent upon a running down of asset stocks or increasing liabilities as a result of net operating deficits) can indicate the non-sustainability of present fiscal policies.

In addition, a Cash Flow Statement is prepared and presented in the usual format of operating, investing and financing transactions.

The GFS system based on accrual accounting is a superior information system to CABS. It is a comprehensive FMIRS which is tailored to provide governments with appropriate information required for the good fiscal management of their economies, and as well on all the assets and liabilities of the government for resource management purposes. Hence its net worth, and the total operating costs of departments and programs, can also be calculated. It can satisfy all the requirements

for quality information specified in SAC3 of relevance, reliability with representational faithfulness, comparability and understandability. The information provided is relevant for the five major areas of fiscal policy management. All the reasons for the use of CABS for fiscal policy purposes apply equally to the GFS system as both are based on reporting transaction resource flows. However in principle GFS is preferable because the recording of transactions as they occur matches the timing of the resource flows. But it should be noted that for the vast majority of government operating transactions, the time difference between the two is not significant. Over 80 per cent of Australian Government expenditures are cash transfers and the regular payroll comprises another 10 percent. By designing the GFS system to report simultaneously on cash and accrual transactions, the benefits of both systems can be obtained – GFS information for fiscal policy management and CABS for cash management and parliamentary cash appropriations. Furthermore, the current value basis used in the system underlies the economic theory of efficient resource allocation, a major function of accounting information systems. Finally, the information produced from the GFS system is closely linked to the other macroeconomic statistical systems including the national accounts, balance of payments and all the monetary and financial statistics produced by the government. All these important economic statistical systems are thereby integrated and mutually consistent.

Finally, it should be noted that presentation of the budget on a GFS basis has been confined to date to the GGS for macroeconomic management purposes. It has not been applied at the departmental level for the management of resources and liabilities, and for operating cost management of departments and programs, i.e., the final role of government. This has been the preserve of the AAS AABS system. However, the GFS system can be readily applied at the departmental level. In my opinion, it would provide better quality information for departmental management purposes and avoid many of the limitations of the AAS system as applied to government. It readily satisfies the SAC3 requirements for quality information. The GFS system applied at the micro level is essentially the Current Cost Accounting system based on physical capital maintenance. This system is explained in Barton (1984, Chaps 24 and 26) and in SAP1 (1983). Thus the GFS system could be used as a comprehensive FMIRS for the GGS for both macro and micro-economic management.

(b) **Australian Accounting Standards Accrual Accounting and Budgeting System (AA S AABS)**

AAS were originally formulated by the AASB for business entities and subsequently applied, with some minor modifications, to the public sector. The standards developed specifically for the public sector (AAS29 and AAS31, 1996) adopt the same principles as the business standards and make allowances only for some different administrative arrangements in government. They are used throughout all government departments (as required by AAS29) and a consolidated set of financial statements is prepared for whole-of-government (as per AAS31) including financial and business enterprises. They are all subject to audit by the ANAO. AAS are heavily influenced by US and IASB standards because of the need to harmonise accounting standards in a world of global business. The IASB standards replaced the Australian standards on 1 January 2005 under the Corporate Law Economic Reform Package.

The focus of AAS is on the preparation of information on accounting transactions and events to be included in General Purpose Financial Reports (GPFs) for those stakeholders who have limited access to information about the entity. GPFs comprise statements of financial performance and position, and a cash flow statement. Their objectives are stated (SAC 2, 1990, paras 43-45) as the provision of information useful to users for resource use decision making, evaluation and accountability purposes and for assessing financial performance and position, and financing and investing, activities.

However, the standards suffer from some major limitations, even for the business sector (Wells et al, 2003). For example, they are not based on a consistent *financial measurement system* because the key concepts of profit and capital maintenance are not adequately defined, and the basis of asset and liability valuation is not prescribed. These matters affect asset consumption charges and recognition of holding gains and losses and hence the measures of profit, assets and liabilities. The notion of profit measured is an all-inclusive one ('comprehensive income') of the change in equity resulting from all transactions and events of the period, except for changes in direct ownership investment. Hence it includes recognised unrealised holding gains and

losses even though they may not represent increases in recorded wealth which add to the entity's spending ability (such as an increase in the current replacement cost of public roads and drains which do not generate revenue and cannot be sold). The measure of 'comprehensive income' in such circumstances can lack validity, and it is difficult to make valid interpretations of financial performance and position. Defects in the standards and in the published financial statements are graphically illustrated in each wave of corporate collapses which tend to occur about every decade (Sykes 1994; Clarke, Deane and Oliver, 2003).

But the standards suffer as well from a lack of relevance in many key attributes when applied to the public sector. Being designed to satisfy the financial information needs of business firms, their focus is on the measurement of profit and financial position in GPFs for investors and creditors. But governments are not concerned with these purposes. Their role is to provide collective and social welfare goods and services to citizens, funded from taxation, rather than to produce and sell personal items to buyers for profit. The AASB has adopted the principle that the same accounting standards should apply across all areas of economic activity, i.e. be sector neutral (McGregor, 1999, p3¹). Only minor variations are allowed for specific industry characteristics and the public sector is treated as being just another industry. The most important variation allowed is for departments to distinguish between 'administered items' (for example, transfer payments made according to legislation) and items controlled by departmental management. The Board does not accept that there are fundamental differences between the public and private sectors arising from their different nature and roles. Adoption of the sector-neutral principle has resulted in the standards not being adequately adapted to suit the information needs of government. This seriously limits their relevance. It is examined in Barton (2005, pp140-141).

These additional limitations of AAS systems for the public sector include:

- A different and more fundamental role for accountability (Mulgan 2000). The major purpose of outcome financial statements is to fulfil accountability obligations to parliament and the public rather than to serve resource use decision making purposes. Democratic governments are accountable to citizens for all their activities. This requires that parliament and the public are kept fully

informed of government policies and activities. Parliament can demand full access to specific information (subject to security and commercial-in-confidence considerations). Hence the distinction between general purpose financial reporting and management reporting in the public sector is not a sharp one. Government budgets and departmental reports are public documents unlike their business counterparts, which are for internal management use only.

- The concept of control which forms the basis of the entity concept is not appropriate for the public sector and, for example, until this year it was used to exclude the General Government Sector as an accounting entity (refer to page 13 above, and to Challen and Jeffery 2005). The control concept used to define a business entity relates to the capacity of the entity to dominate the decision-making of another (SAC1, 1990, para 6). However, while statutory agencies and public corporations are owned by government, their charters are determined by government (through legislation). Their governing boards are accountable to government and are given statutory independence which constrains ministers' abilities to influence their day-to-day operations. This is the reason why such bodies are not included in the budget sector.
- Nature of government departments as separate entities under AAS29. Departments are merely the administrative arms of government which deliver services to the public as determined by government, and are funded to do so from tax revenue. They are cost centres rather than revenue generating profit centres and they have no assets or liabilities.
- An inappropriate concept of assets. Assets are defined as "...future economic benefits controlled by the entity as a result of past transactions or other events", and control is defined as "... the capacity of the entity to benefit from the asset" (SAC4, 1990, para 14). Rather, most government non-financial assets are acquired to provide non-cash services to citizens – defence, health, education, roads, and so on, rather than to generate revenue for the government. Alternative asset definitions are given in Barton (2005, pp149-50).
- Definitions of the related concepts of revenue, liabilities and equity are not specifically related to the public sector as they are based on an inappropriate definition of assets. For example, governments raise most of their revenue from taxes rather than from user charges for goods and services provided to citizens,

many liabilities arise from social welfare obligations to citizens rather than from credit purchases or borrowing, and governments do not need contributed equity.

As a consequence of the above limitations of the AAS system and the different operating environments of governments, AAS financial statements of governments suffer from serious limitations with respect to their information usefulness. These include:

- The statements are of no use for fiscal policy purposes. They are based on a balance sheet approach for the analysis of transactions and events, whereas fiscal policy management requires the use of a resource flows and stocks approach.
- The absence of a rigorous financial measurement system and some key definitions limits the reliability of information and its comparability across different jurisdictions within Australia and internationally. The AAS statements could not be used, for example, for the preparation of the national accounts and the measurement of key economic concepts such as the Gross Domestic Product.
- The statement of financial performance lacks representational faithfulness if it is interpreted similarly to its business counterpart and would be misleading. Taxation revenues cannot be interpreted similarly to sales revenues, and the budget balance is not comparable to a profit or loss. A budget surplus is the difference between the cost of service provision and the appropriations made to fund them, and is not a source of funds to pay dividends. It can be readily altered through changing appropriations or the services provided. The statement is more accurately termed an 'operating statement' as it summarises department and GGS operations over the period.
- Likewise, a government statement of financial position lacks representational faithfulness as it does not aim to show this in a business sense. Most of its non-financial assets are not revenue-generating, and the statement does not include the most valuable of all government resources, viz. the sovereign power to tax. Rather, it is a list of government assets and liabilities and is better termed a 'balance sheet'. Moreover, if the negative equity of the Government as at the end of each year (for example, - \$42,686m at 30 June 2004), were judged by business criteria, then it is seriously bankrupt. But governments do not require contributed capital to fund their assets because of their taxing powers. Finally, although

departments publish statements of financial position showing “their” assets and liabilities, in fact they have none. Rather, they are government resources for which they have some management responsibility.

Hence, in its present form the AAS system is unsuitable for the use of government because of its lack of sufficient conceptual and analytical rigour, and lack of relevance. These deficiencies largely result from departures from the rigorous conceptual framework approach for the development of the standards as espoused in Policy Statement 5 (1995), and the ideological belief that business standards should be applied to the public sector so that the standards can be sector neutral. As a consequence of these serious limitations of the AAS system of financial measurement for the public sector, the financial statements lack representational faithfulness and the information provided fails to satisfy adequately the criteria for useful information of relevance, reliability, comparability and understandability.

CONCLUSIONS

The present system of accounting in the Australian Government is untenable with the presentation of two sets of accrual budget statements and outcome financial statements which show very different results for all components; and secondly, the absence of CABS which is needed for fiscal policy purposes, appropriation bills and good cash management. In principle, the solutions are obvious ones, i.e. –

- a) the reintroduction of CABS as a subset of AABS for the direct recording and timely reporting of cash transactions as occurred prior to 1999; and
- b) harmonisation of the sound features of AAS and GFS into one combined, robust accrual accounting FMIRS system which is based on the GFS model and is relevant for the public sector.

The Government recognises the problem and work is underway towards its resolution. Serious consideration is currently being given to the reintroduction of CABS using the direct method as a component of AABS. The Heads of Treasury Committee is currently analysing the two AAB systems and making recommendations to the AASB for changes in each in order to harmonise them wherever possible. Notwithstanding the many differences between the two systems, it should be acknowledged that there are also substantial overlaps between them. Most of the AAS concerning transactions recognition

and recording, and those items which are not mainly unique to the public sector, can be readily applied to the public sector. The major deficiencies in AAS arising from their lack of sufficient conceptual and analytical rigour, consistency in the use of standards and their relevance to the public sector, can be overcome if there is the will to do so.

Similarly there are some deficiencies in the GFS system which need to be remedied, such as the expensing of all expenditures on new military equipment. Making appropriate changes to each system would enable harmonisation of the systems and the use of one comprehensive accrual and cash FMIRS in government which provides relevant, reliable, comparable and understandable information on government activities for decision making, management control and accountability purposes. The prospective benefits from harmonisation and reintroduction of CABS as a component of AABS are substantial.

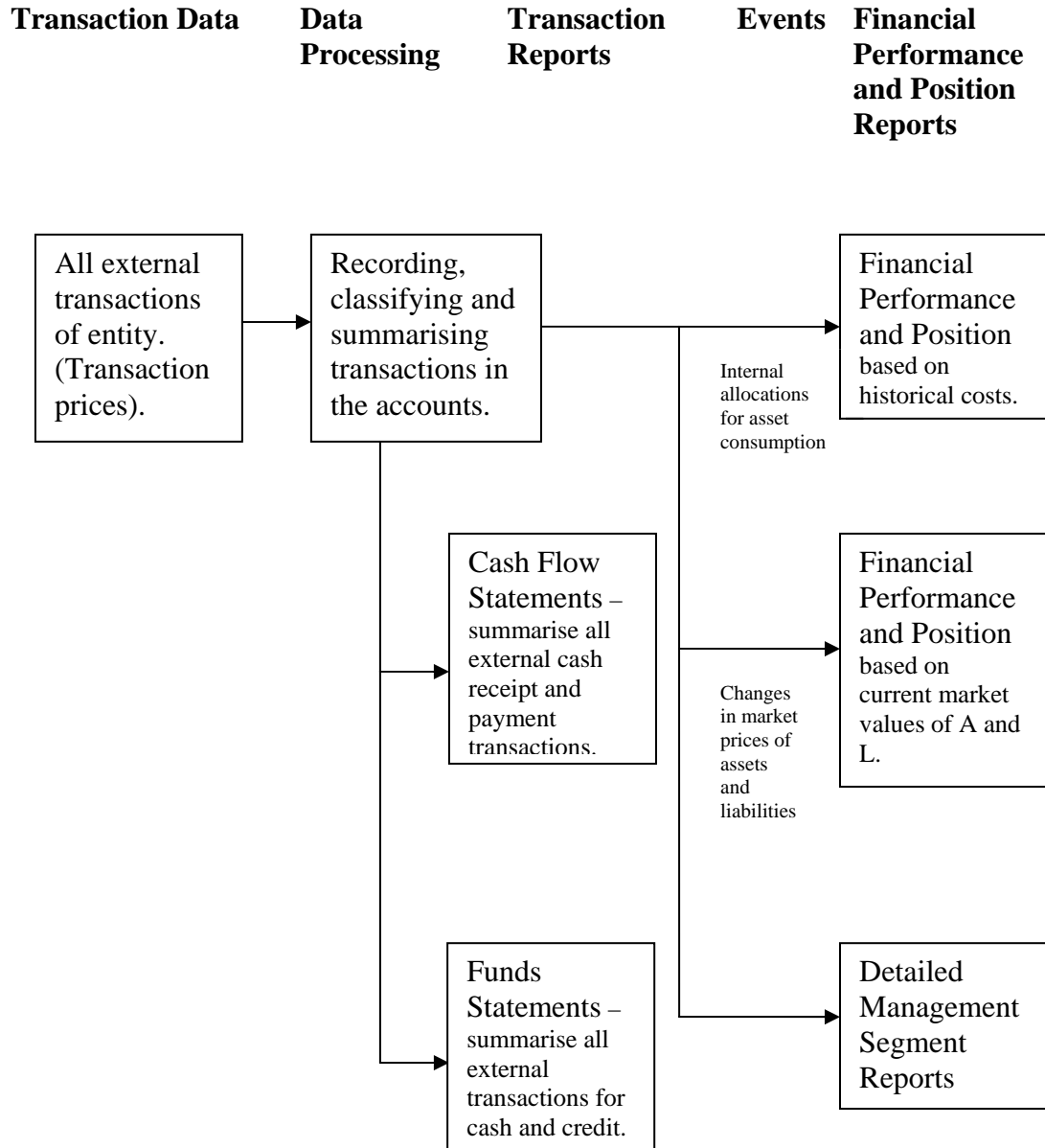
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Footnote

1. Mr McGregor was Director of the Australian Accounting Research Foundation when the draft standards were developed for the AASB.

APPENDIX 1

FRAMEWORK FOR FINANCIAL MANAGEMENT INFORMATION AND REPORTING SYSTEMS



APPENDIX 2
STATEMENT OF GOVERNMENT OPERATIONS

TRANSACTIONS AFFECTING NET WORTH:

REVENUE

Taxes
Social contributions
Grants
Other revenue

EXPENSE

Compensation of employees
Use of goods and services
Consumption of fixed capital
Interest
Subsidies
Grants
Social benefits
Other expenses

*NET/GROSS OPERATING BALANCE*¹

TRANSACTIONS IN NONFINANCIAL ASSETS:

NET ACQUISITION OF NONFINANCIAL ASSETS²

Fixed assets
Change in inventories
Valuables
Nonproduced assets

NET LENDING/BORROWINGS³

**TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES
(FINANCING):**

NET ACQUISITION OF FINANCIAL ASSETS

Domestic
Foreign

NET INCURRENCE OF LIABILITIES

Domestic
Foreign

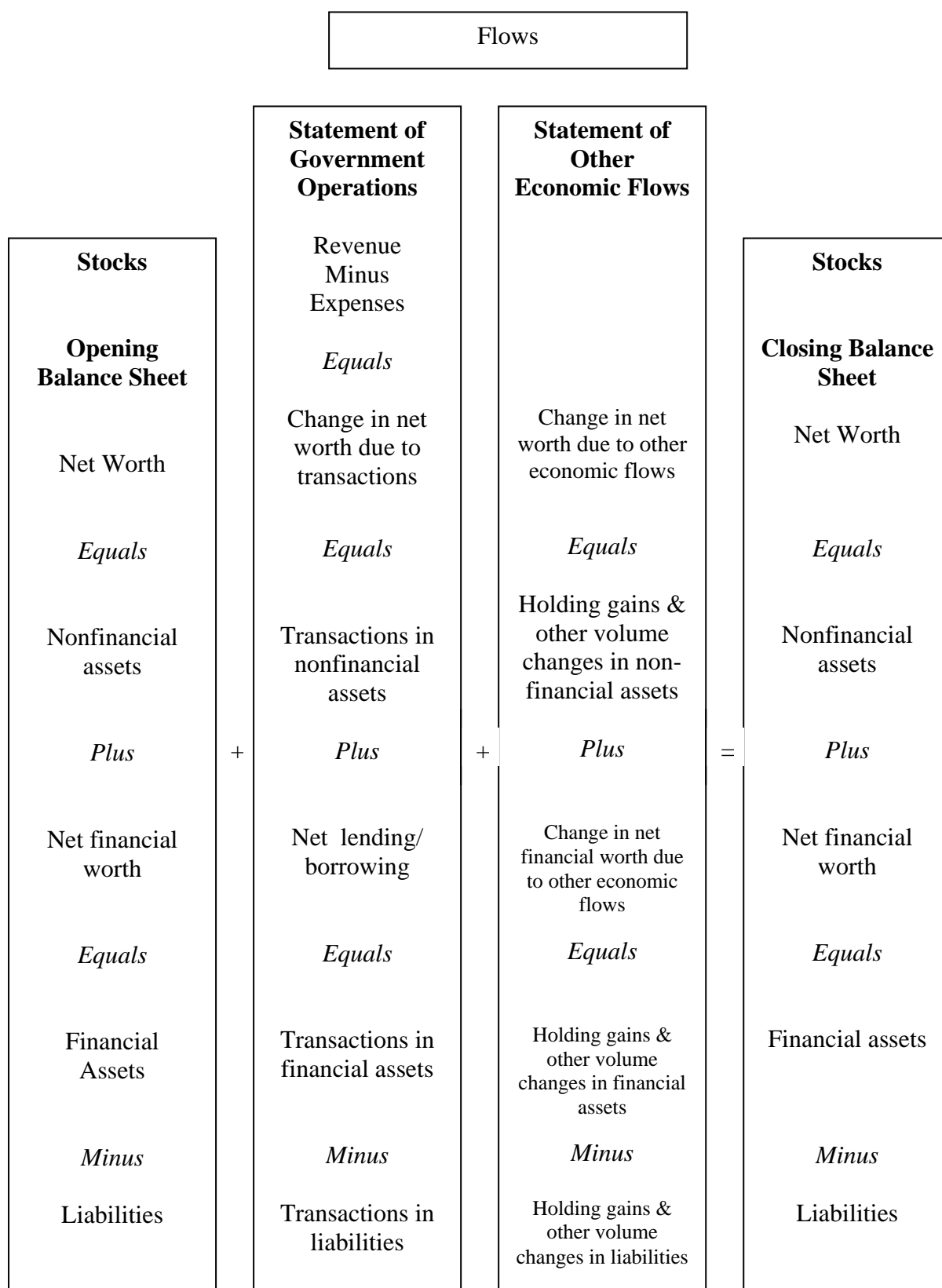
¹The net operating balance equals revenue minus expense. The gross operating balance equals revenue minus expense other than consumption of fixed capital.

²Acquisitions minus disposals and consumption of fixed capital.

³Net lending/borrowing equals the net operating balance minus the net acquisition of nonfinancial assets. It is also equal to the net acquisition of financial assets minus the net incurrence of liabilities. Source: Government Finance Statistics Manual 2001, Table 4.1 p.38.

APPENDIX 3

STRUCTURE OF THE GFS ANALYTICAL FRAMEWORK



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