<u>Session 1 Notes: Case for and Against</u>

Initial Issue – What does Government hope to achieve by changing its system of accounting and financial management?

- More efficient resource allocation
- Lower cost
- More effective control over expenditure
- Improved control over assets and liabilities
- Reduction of financial risk
- More predictability of expenditure
- Separation of operating cost from capital expenditure
- Greater transparency of Government's financial affairs
- Maintenance of operating capacity
- Preservation of taxpayer's capital
- Basis for improved financial management incentives
- Comparability with other jurisdictions
- Comparability with private sector (for outsourcing, etc)

Advantages of Accrual Accounting

- Separates Revenue and Expense from Asset and Liability – i.e. disaggregates data and distinguishes operating cost from investment
- The matching principle records economic activities in the period in which they occur, regardless of when the cash settlement is completed – reveals underlying economic activity which may be obscured by cash accounting
- Used and understood globally by the private sector – makes government finances more transparent and understandable
- Reveals underlying fiscal surplus or deficit – thus supports more responsible and sustainable fiscal management
- Recognises non-cash costs ignored under cash accounting – such as depreciation, consumption of inventory or unfunded superannuation expense
- Distinguishes between different types of financial instruments - such as operating and finance leases
- Reduces budgetary manipulation at year end – for example by revealing prepayments
- Reveals financial health of the entity – by disclosing the liquidity of assets and the size and type of liabilities
- Supports capital maintenance - by distinguishing between operating revenue and asset disposal proceeds

Advantages of retaining Cash Accounting

- Cash accounting highlights cash flow – this remains the primary financial management concern of govnerment
- Cash accounting is simple to apply, with few rules to apply or judgements required by preparers – staff skill requirements are reduced
- Cash reports are quick to compile – an 'instant' report on the financial position of an individual entity or an entire jurisdiction is often available on-line

- Cash accounting is well suited to fund management – using separate types of bank account to control receipts and payments for differing purposes (for example, to separate recurrent payments from capital purchases)
- Budgetary management can be applied to entities through limitations on access to cash at the point of payment – a simple control tool
- Cash accounting is well suited to centralised accounting systems – leading to low cost and efficient accounting arrangements for large jurisdictions.
- Cash accounting can be supplemented by year end adjustments to modified cash reporting with the main characteristics of accrual-based information.

What factors determine whether it is worthwhile to switch from cash accounting to accrual accounting?

- Characteristics of jurisdiction – for example a jurisdiction with few assets and liabilities and business comprising mainly cash receipts and payments may be well served by cash accounting
- Financial management objectives – is accrual information necessary to support the financial management objectives of the jurisdiction (for example, to improve inventory management or credit control, to support outsourcing or output costing, or to improve long-term fiscal management)
- Systems capability – can conversion to accrual accounting be achieved without the need to replace the accounting system?
- Cost of changeover – does the jurisdiction have the resources to afford both the initial outlay and subsequent operating costs of conversion from cash to accrual accounting?
- Skills availability – does the jurisdiction have access to the professional accounting skills and systems administration skills to operate an accrual based system?
- Speed of reporting – can the jurisdiction accept the longer delays in month end reporting for accrual information compared to cash information?
- Legal form of appropriation – does the constitution, or other paramount legislation, require Parliamentary appropriation of cash, or does it allow for appropriation of accrual expense?

Budget Transparency

What is meant by budget transparency?

- Avoidance of 'hidden' costs (or revenues) within the budget estimates – for example, unfunded pension liabilities, or income tax windfalls due to bracket creep.
- Separation of capital investment from operating expenditure
- Clarity of spending asset sales proceeds on recurrent costs
- Distinguishing between operational budget decisions and valuation adjustments – for example revenue from sale of government services (operational) v gain on revaluation of property assets (valuation)
- Separation of 'departmental' expenditure from 'administered' expenditure - to reveal true departmental operating costs from transfer payments or purchases of 'crown' or 'state' assets
- Distinguishing between purchase of inputs and production of outputs

<u>Better accounting of long term assets and future liabilities</u>

Treatment of long-term assets under cash accounting:

- Cash accounting only records assets at initial purchase (and any eventual disposal proceeds)
- Cash accounting does not recognise assets donated or received free of charge, or by barter (non-cash) exchange
- Cash accounting does not recognise self-constructed assets created through recurrent spending
- Cash accounting does not distinguish between the differing length of useful lives of various asset types - and therefore fails to recognise remaining value of an asset
- Cash accounting does not recognise depreciation – the consumption of the asset over time
- Cash accounting does not recognise revaluation of assets over time – whether due to inflation or increased demand
- Modified cash accounting can compensate for some of these shortcomings – for example, through the creation of an asset register, separation of accounts for asset purchases from operating expenses.

Treatment of future liabilities under cash accounting:

- Cash accounting does not record future liabilities at time of incurrence – only when payment fall due
- Cash accounting fails to identify the full cost of current purchase decisions by ignoring any deferred costs (liabilities) arising from the decision (for example – staff pension liabilities incurred in an unfunded pension scheme)
- Cash accounting does not distinguish between debt funding and tax revenue – despite the long term liability associated with debt and the impost on current private sector consumption associated with tax

Treatment of long-term assets under accrual accounting:

- Accrual accounting does not regard the purchase of an asset as a cost, but as an investment. Only asset depreciation appears as an operating expense.
- Self-constructed assets can be valued from the cost of the labour and material inputs. This is problematical from a budget perspective, as budgets will usually have been based on operating expense.
- Periodic revaluation (without asset realisation through sale) can provide correction to entity value
- Inventory is held as an asset and expensed upon consumption, rather than at point of purchase, thus more correctly matching inventory consumption to period of use
- Assets under construction are not depreciated until commissioned, thus more correctly matching asset consumption to period of use

Treatment of future liabilities under accrual accounting:

- Accrual accounting identifies the future cash costs of current decisions. However, this remains problematical if budgets are set on a cash basis whilst accounting is accrual-based, as the budget will not reflect full cost and will not be comparable to the subsequent accounting results.

- Correct identification and valuation of future liabilities with the introduction of accrual accounting has had a major impact on leading to more sustainable budget decisions in Australian Federal and State Governments.

<u>Enhancing Government Efficiency through performance based management</u>

Approaches to performance based management:
- CEO Contracts
- Performance bonuses
- Output specifications – Quantity, Quality, Timeliness, Cost (QQTC)
- Management discretion over use of inputs
- Financial incentives – including ability to retain surpluses, ability to retain asset sales proceeds, funding for asset depreciation, ability to retain additional revenues from sales of goods and services, capital charge, interest on bank earnings
- Cash disbursement profile / Net fiscal impact limits
- Legal limits on in-year transfers between output classes
- Supplementary Appropriation and central funds transfers
- Outsourcing
- Competitive tendering
- Central procurement
- Mode C (NZ model - appropriation for price)

<u>Technical Issues arising during implementation</u>
- See case studies

<u>Consistencies in the treatment of assets and future liabilities</u>
- Depreciation methodology
- Actuarial valuation of liabilities
- Financial assets – effect of market revaluations

<u>Development and maintenance of uniform standards</u>

- GAAP, IPSAS, IFRS, GFS,
- Financial Regulations

<u>Stringent methods of valuation</u>

- Historic cost
- Fair value (including future use value for special purpose assets)
- Market value
- Depreciated replacement cost
- Going concern or surrender value