ED 142 sub 10

Australian Government

The Treasury

OFFICE OF THE SECRETARY

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Contact: Craig Jeffery
Phone: (03) 6233 3638
Our Ref: D/001261 CJ/DWC

Professor David Boymal
Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS ST WEST VIC 8007

Dear Professor Boymal

EXPOSURE DRAFT 142 – FINANCIAL REPORTING OF GENERAL GOVERNMENT SECTORS BY GOVERNMENTS

Australia's Heads of Treasuries (HoTs) welcome the opportunity to respond to the Australian Accounting Standards Board's (AASB) Exposure Draft 142, *Financial Reporting of General Government Sectors by Governments*.

As you are aware, HoTs regard harmonisation between Generally Accepted Accounting Principles (GAAP), applicable to the public sector, and Government Finance Statistics (GFS) as the highest priority for Australian public sector reporting. For this reason, HoTs has maintained a very close ongoing interest in this Project and has devoted significant resources to support the AASB, through its contribution to Project reference committees, consultative forums and through a Working Group of its Accounting and Reporting Advisory Committee (HoTARAC).

HoTs acknowledge that substantial progress has been made by the AASB in resolving many of the conceptual and technical issues. However, the consensus view of Australia's Treasuries is that the Exposure Draft fails to harmonise GAAP and GFS to any meaningful degree. This failure to harmonise the two reporting frameworks is a fundamental concern to HoTs. In our opinion, this failure clearly means that the proposed standard does not comply with the Financial Reporting Council's (FRC) December 2002 strategic direction to the AASB.

The FRC's strategic direction requires the AASB to achieve an Australian Accounting Standard for a single set of Government reports which are auditable, comparable between jurisdictions and in which the outcome statements are directly comparable with the relevant budget statements. The FRC's apparent objective is to increase the transparency and accountability of governments by removing the confusion associated with the publication of two sets of financial statements. HoTs consider that the Exposure Draft, as currently presented, would result in a significant reduction in the understandability and comparability of government general purpose financial reports. Consequently, in our view, the Exposure Draft fails to meet the FRC's objectives.

The Exposure Draft does not harmonise the GAAP and GFS frameworks to a single conceptual accounting framework, and therefore will not deliver government general purpose financial reports that are comparable, understandable, relevant or reliable. As an example of the complexity resulting from the Exposure Draft, the "Operating Surplus", which is buried in the overwhelming detail of the Operating Statement, will have two different measures attached to it.

It is HoTs view that the reconciliation-based approach in the Exposure Draft would significantly increase the complexity of government financial reports and seriously reduce the understanding of users. It is for this reason that HoTs strongly disagree with the Exposure Draft in its present form and, accordingly, would not support this Exposure Draft being progressed to a resultant Australian Accounting Standard.

HoTs consider the illustrative multi-column format presented in the Exposure Draft to be an extremely unwieldy and impractical presentation that will seriously impair the usefulness of government general purpose financial reports. In order to harmonise a GAAP-GFS presentation, HoTs recommend that the AASB mandates the treatment of outstanding convergence differences identified in Appendix 2. The resultant government general purpose financial report can then be presented in a useable, "down-the-page" format, as illustrated in Attachment B of Appendix 1 to this submission.

A second issue of concern to HoTs relates to the presentation of GFS-based aggregates in the government general purpose financial report. Given the level and significance of user interest in such aggregates as the Fiscal Balance (Net Lending/Borrowing), Net Worth and Cash Surplus, HoTs support the AASB's decision that GFS-based aggregates should appear on the face of the government general purpose financial report. However, HoTs are concerned about the proposed form in which such presentations will occur, due to the potential for duplication of measures and the resultant confusion of users. HoTs recommend that the AASB removes the requirement to report certain GFS-based aggregates which are not relevant to general users, such as the "net increase (decrease) in financial assets and liabilities". These aggregates are able to be derived from the statements by those with specialised interests.

Subject to the AASB agreeing to deliver complete harmonisation of GAAP and GFS, HoTs strongly recommend that the GFS-based aggregates should be derived from the resulting fully harmonised numbers in the financial report, maintaining the "flow" of the numbers through the report. Disclosure of any further information on GFS aggregates, including any reconciliation with the aggregates shown on the face of the statements to a "pure" version of GFS, should be restricted to the notes only.

As noted in my previous letter to you of 19 December 2003 and as discussed at the meetings of HoTs and some members of the AASB on 14 July 2004 and 2 February 2005, HoTs is strongly of the view that, for effective harmonisation to be achieved, it is essential that the harmonised standard requires general purpose financial reports for the General Government Sector.

General Government Sector financial reports are important to users because they facilitate an assessment of the economic impact of the Government's fiscal policy initiatives. HoTs strongly support the AASB's decision that defining the General Government Sector as a general purpose reporting entity ensures that the required information is provided to users unable to command the preparation of reports tailored to specifically satisfy their needs. This approach recognises that the public accountability of governments for budget outcomes is a fundamental difference between the public sector and the for-profit sector. It is essential that governments are transparent and accountable for their activities and budget outcomes, and the government general purpose reporting entity is determined by reference to the information needs of users.

Also as noted in my letter of 19 December 2003, reports for other sectors and for the whole-of-government reporting entity will continue to be produced for the benefit of users of government accounts. Therefore, there should be no potential risks of users focussing solely on General Government Sector general purpose financial reports, without regard to the additional information provided in whole-of-government financial reports.

HoTs also strongly support the AASB's decision that the General Government Sector general purpose financial report should be prepared on a partial consolidation basis, together with the associated prohibition of consolidating entities in the Public Non-Financial Corporations Sector and the Public Financial Corporations Sector. We note that this is consistent with the approach taken by the International Public Sector Accounting Standards Board in their proposed standard "*Disclosure of Financial Information about the General Government Sector*".
To summarise our position, HoTs commend the considerable progress that has been made by the AASB to date in resolving a number of major conceptual and technical issues in the development of the Exposure Draft. However, there are a number of significant issues remaining to be resolved by the AASB, as outlined above, before the outcome of its Harmonisation Project will meet the needs of users or the requirements of the FRC's strategic direction. In order to progress this high priority Project, HoTs believe that, in light of its comments, the AASB should undertake a major review of the Exposure Draft, and then issue a new Exposure Draft for stakeholder comment. HoTs recognise that this would necessitate deferral of mandatory application of the GAAP-GFS reporting standard until 2007-08.

HoTs would be pleased to provide the AASB with any additional assistance, information or clarification that may be required to support the proposed rework of the Exposure Draft. HoTs support a standard for the General Government sector reporting entity that:

- Provides for an auditable general purpose financial report, but excludes the need for explanations of variance between budget and actual to be audited;

- Consolidates investments in entities in other sectors as a single line based on either fair value or net assets of those entities;

- Requires adoption of one approach based on the conceptually best treatment, for those items where there is a significant difference in recognition or measurement between the GAAP and GFS frameworks;

- Clearly expresses support for "down-the-page" presentation in the financial statements, with separate identification in the Operating Statement of those items that, under the GFS framework, would be "transactions" and those that would be "other economic flows" (remeasurements). Where convergence introduces items that are not in the GFS framework, this will require a decision as to where they conceptually fit;

- Presents on the face of the financial statements certain significant GFS-based measures that are derived from the numbers presented within those statements; and

- Otherwise complies with accounting standards.

The attached submission (Appendices 1 and 2) provides a detailed explanation of HoTs conclusions and recommendations.

I trust that the above comments will assist the AASB to progress this important matter.

Yours sincerely

Ken Henry
CHAIR
HEADS OF TREASURIES

Encl

Appendix 1

Specific matters for comment

The specific issues identified for comment by the Australian Accounting Standards Board (AASB) are addressed below in the order they appear in Exposure Draft 142:

a) **The proposal in paragraph 5 that the GGS of a government is a reporting entity**

As noted in the cover letter, Heads of Treasuries (HoTs) strongly support the proposal that the General Government Sector (GGS) of a government is a reporting entity.

Defining the GGS as a general purpose reporting entity that reports on the entities, transactions and activities which are within the GGS, enables governments to be transparent and accountable for their activities, in a form that is comparable across jurisdictions.

The GGS is essentially the budget sector (ie the "core government" reporting entity) in all jurisdictions. There are large numbers of key users that are dependent on GGS based general purpose financial reports (GPFR), particularly in relation to accountability for budget outcomes. Given that the budget sector represents the principal means of government service delivery and income and wealth redistribution, the majority of users are significantly more interested in the financial performance of the GGS, rather than the results of the Total Public Sector.

HoTs consider that the needs of users must be paramount in determining the scope of the reporting entity. Their needs are ignored if the information in financial reports is obscured by consolidating information relating to entities that do not form part of core government. Users want to know about the equity-like and equity interests of core government in other entities. Their needs are best met by revealing those equity interests as a single line item in the core government financial reports.

The preferred approach is for a GPFR for the core government reporting entity prepared on a partial-consolidation basis. An entity known as the GGS, defined according to Government Finance Statistics (GFS), is the best candidate to define this core government reporting entity.

Attachment A provides further discussion of the case for treating the GGS as a reporting entity.

b) **The proposal, implicit in paragraph 5, that a GGS financial report prepared on a partial consolidation basis is a GPFR together with the proposal in paragraph 18 that the GGS should be prohibited from consolidating controlled entities in the PNFC sector and the PFC sector**

HoTs strongly support the proposal that the GGS financial report, prepared on a partial consolidation basis, is a GPFR. HoTs support prohibiting the full consolidation of entities in the Public Non-Financial Corporation (PNFC) sector and the Public Financial Sector (PFC) sector by the GGS.

The concept of control, as it applies in the for-profit sector, is not readily applicable to the public sector, when determining whether a reporting entity is relevant to the activities of the Executive Government. This is because if the GGS were to be determined on the basis of the conventional for-profit sector control tests, in most jurisdictions there would be little difference between a GPFR for the expanded GGS entity and a fully consolidated whole-of-government GPFR.

However, as users are interested in knowing how effectively government policies for the allocation of public funds have been delivered, the GGS (i.e. the budget sector) is significantly more relevant as the general purpose reporting entity of the government.

Attachment A provides further discussion of the partial consolidation basis.

c) **The proposal in paragraphs 8 to 12 that, with limited significant exceptions, the GGS financial report should comply with other Australian Accounting Standards and, where it does not conflict with Australian Accounting Standards, GFSM 2001. The Board is particularly interested in comments on the proposal that where Australian Accounting Standards allow for optional treatments, only those treatments aligned with GFSM 2001 should be applied for the purposes of GGS financial reporting**

HoTs strongly support the proposal to adopt policies that align with GFS where Australian Accounting Standards/Generally Accepted Accounting Principles (GAAP) allows for optional treatments. This is a crucial element of harmonisation of GAAP and GFS as, in most cases, it allows GFS treatments to be adopted within the GAAP framework. Where no conflict between the two frameworks exist, it is appropriate to select the accounting policies that advance the objective of a single harmonised statement. This also contributes to consistent and comparable treatments across jurisdictions.

The Financial Reporting Council's (FRC) strategic direction in 2002 was for the harmonisation of GAAP and GFS. HoTs note that notwithstanding the requirement to select options that align with GFS treatment, a number of "convergence differences" remain. HoTs consider that harmonisation can only be achieved if convergence differences are eliminated. An outcome that includes significant convergence differences will represent a reconciliation of the two separate frameworks, rather than a single set of statements.

The convergence differences set out in the Appendix B of Exposure Draft 142, although limited to a small number of issues, can lead to significant dollar values, particularly for the Australian Government (convergence differences of over $28 billion in the Balance Sheet, as illustrated in Appendix B).

HoTs note that, whilst the financial report being auditable is a major step forward, the fact that there is a reconciliation and multiple "bottom line measures" will cause significant confusion for users. It also means that the Exposure Draft does not comply with the FRC's strategic direction on harmonisation.

d) **The proposal in paragraphs 13 to 17 to require or allow disclosure of information in the GGS financial report that is determined in accordance with GFSM 2001 and, where it is determined in a different manner from corresponding information prepared in accordance with Australian Accounting Standards, provide a reconciliation to the GFS-related information**

HoTs strongly support the proposal to disclose GFS information in the GGS financial report.

While, in the majority of instances, options in GAAP allow for GFS treatments to be adopted, there are a small number of areas where differences remain. Under the approach adopted by the Exposure Draft, the existence of these differences results in two sets of financial aggregates being presented on the face of the financial statements. This results in significant difficulties in presenting financial statements in a clear and understandable format, which in turn will lead to confusion among users of the financial statements. Presenting a single set of financial aggregates on the face of the financial statements removes the need for reporting of the convergence differences illustrated in Appendix B of the Exposure Draft. It also simplifies the presentation of harmonised financial statements.

It is important to ensure that the financial report focuses on presenting information regarding the financial performance and position of the GGS, not on the differences between GFS and GAAP in the recognition, measurement and presentation of individual items.

HoTs consider that the GGS financial aggregates presented should be based on the conceptually best treatment, either GFS or GAAP. This approach will ensure that the best quality financial statements are presented, will ensure that the FRC's strategic direction is satisfied and will ensure that financial statements are clear and understandable.

The approach proposed by HoTs is that, where there are differences between GAAP and GFS, the conceptually best accounting policy should be mandated in the Exposure Draft.

There are six issues where significant convergence differences remain. These are:

- Provision for doubtful debts;
- Treatment of dividends from PNFC and PFC Sectors (where paid out of prior profits or funded from asset sales);
- Defence weapons and weapons platforms;
- Subscriptions to the International Development Association/Asian Development Fund;
- Currency on issue; and
- IMF special drawing rights.

HoTs consider that GAAP is the conceptually best treatment for these items with the exception of dividends from PNFC and PFC Sectors (where paid out of prior profits or from asset sales) and subscriptions to the International Development Association and Asian Development Fund. In these instances the GFS treatment is considered to be conceptually best. These issues are discussed in further detail in Appendix 2 of this submission.

If the approach outlined above is adopted, the GFS measures reported on the face of the financial statements may not accord with the Australian Bureau of Statistics' (ABS) interpretations of GFS (ABS GFS). HoTs propose that the ABS GFS aggregates are provided in the notes to the financial statements, including a reconciliation between the harmonised information on the face of the financial statements and ABS GFS. The HoTs reasons for adopting ABS GFS in place of applying IMF interpretations of GFS are set out in point (p) below.

e) **The proposals in paragraphs 19 to 23 that:**

(i) the GGS's equity investment in non-consolidated controlled entities should be measured at fair value where fair value is reliably measurable and at the government's proportional interest in the net assets of the controlled entities where fair value is not reliably measurable;

(ii) where net assets is used as the basis of measurement, it is determined in a manner consistent with the net assets that are consolidated into the whole of government GPFR;

(iii) changes in the carrying amount of the GGS's equity investment in non-consolidated controlled entities during a reporting period are treated in a manner consistent with the treatment of a change in fair value under AASB 139 even if the carrying amount is not fair value; and

(iv) specify the treatment of jointly controlled entities and associates.

HoTs support this approach.

f) **The proposals in paragraphs 26 to 31 relating to the format and content of the Balance Sheet and the treatment of convergence differences**

HoTs support these proposals.

g) **The proposals in paragraphs 32 to 40 relating to the format and content of the Operating Statement and the treatment of convergence differences, including the proposal:**

(i) to mandate the classification of income and expenses by nature on the face of the Operating Statement, with the classification aligned with the GFSM 2001 classification scheme to the extent appropriate;

(ii) to mandate a comprehensive income approach whereby all nonowner movements in equity are recognised in a single Operating Statement; and

(iii) that the option in AASB 119 Employee Benefits (December 2004) of partially deferring actuarial gains and losses on defined benefit superannuation plans using a "corridor approach" should be prohibited, and that the remaining options of recognising them in operating result or in the other non-owner movements in equity section of the Operating Statement should be allowed. The Board is particularly interested in comments on whether the Standard should remove options entirely, and in so doing, prohibit recognition directly in other non-owner movements in equity

HoTs support the proposal to mandate the classification of income and expenses by nature, with classification aligned with Australian GFS Manual – *Government Finance Statistics, Australia: Concepts, Sources and Methods*.

HoTs support the comprehensive income approach adopted but in a "down the page" or single column format for financial statements. This presentation provides a vehicle for presenting a number of items of GFS other economic flows on the face of the Operating Statement, within a GAAP framework, and is therefore central to achieving harmonisation.

HoTs notes that Exposure Draft 142 provides for two of the three options allowed under AASB 119 *Employee Benefits* (AASB 119). HoTs recommend that the treatment of actuarial gains and losses be recognised directly to income. The "direct to equity" and the "corridor approach" options should be disallowed in the interest of comparability across jurisdictions.

Paragraphs 34(c) and 34(d) require the presentation of the net change in financial assets and net change in liabilities, separated into transactions and other economic flows, to be presented on the face of the Operating Statement. This information reconciles Net Lending/Borrowing and Total Other Economic Flows with the movements in major categories in the Balance Sheet. HoTs consider that it would be more appropriate to include this reconciliation in the notes to the financial statements. Note disclosure is consistent with the reconciliation of movements in equity currently provided in the notes to GAAP statements and ensures that the face of the Operating Statement contains only key harmonised GAAP-GFS measures.

The description "Other non-owner movements in equity" should be replaced by 'Other movements in equity", as there is no "owner" in relation to the GGS. This concept is discussed in Attachment A.

h) **The proposals in paragraphs 41 to 43 relating to the format and content of the Cash Flow Statement. The Board is particularly interested in comments on whether the Standards should also require a distinction between cash flows relating to investing in financial assets for "policy" and "liquidity" purposes on the face of the Cash Flow Statement and whether such a distinction would be useful and could be made with sufficient rigour for GPFR purposes**

HoTs support the proposed format and content of the Cash Flow Statement.

The distinction between fundamental cash flows relating to investing in financial assets for policy and liquidity purposes is part of the classification framework used by GFS. Consistent classifications are an important element of GFS and allow users to compare like items across jurisdictions. HoTs consider that the definitions used by GFS are sufficient to distinguish these cash flows.

Investments in financial assets for policy purposes include loans made to other government entities and loans made to other entities for purposes such as industry assistance or assistance to low income earners. Such loans are considerably different in nature to financial assets held for liquidity purposes and are unique to the public sector. Presenting cash flow information about both types of financial investments allows users to make their own decisions regarding the importance of the distinction. Experience suggests that users consider this information important.

i) **The proposals in paragraphs 44 and 45 relating to additional information to be provided in the note containing the summary of significant accounting policies, illustrated in Appendix C. In particular, the Board is interested in comments on whether the proposed disclosures provide sufficient information to minimize the risk that users might perceive the GGS financial report as being a substitute for the whole of government GPFR.**

HoTs support these proposals. Many Governments currently produce budget outcome reports that are restricted to the GGS, in addition to the whole-of-government GPFR. The proposals afford an opportunity to provide greater linkages between the budget outcome reports and the whole-of-government GPFR.

j) **The proposals in paragraphs 46 to 48 relating to additional disclosures. The Board is particularly interested in comments on whether the proposal in paragraph 46(d) to require disclosure of explanations of key technical terms used in the financial report is useful.**

HoTs support these proposals. Most jurisdictions currently provide an explanation of key terms included in budget and financial reports. These explanations include both GAAP and GFS terms in order to assist users to read the reports.

k) **The proposals in paragraphs 49 to 52 relating to disclosures that provide disaggregated information about GAAP and GFS amounts on a functional basis, whereby functions are determined in accordance with GFSM 2001.**

HoTs do not support the proposals. HoTs consider that the proposal to present disaggregated functional information about revenues, assets and liabilities will not result in the presentation of meaningful information because most revenue, assets and liabilities are not attributable to specific functions. For instance, taxation revenues collected by one agency cannot in any meaningful way, be attributable across expenditure functions.

However, HoTs do favour presentation of information on expenses, net acquisition of non-financial assets and user charges, disaggregated by GFS function.

l) **The proposals in paragraphs 53 to 56 to specify principles for the presentation of performance indicators**

Reporting of performance indicators was not envisaged as part of the GAAP-GFS harmonisation project, and is not part of the FRC's strategic direction for harmonisation.

HoTs support the concept of specifying principles for the presentation of performance indicators, but notes that significant work is needed before performance indicators can be considered to be of sufficient quality to satisfy those principles.

It is noted that the scope of performance indicators at the GGS level is limited and that it would be appropriate to include detailed performance indicators regarding service delivery in Departmental, rather than GGS and whole-of-government annual reports. This is because Departments and like agencies are directly responsible for the related activities and outcomes, in accordance with Government governance frameworks.

Accordingly, HoTs recommend the removal from the Standard of the section on performance indicators for the GGS, unless the section is an option for each jurisdiction to apply. Mandating the requirements to report on performance indicators is strongly opposed for the following reasons:

- *Development of GGS Indicators*: A scan of the jurisdictions indicates that most are working on developing better ways of measuring and reporting on performance and setting targets at both these levels. However, it was acknowledged at a recent meeting of jurisdictions that every Government considers that it could improve in this area. In general, while governments may have articulated desired overall outcomes, there has been limited success in devising indicators of how well actual performance achieves those outcomes.

- *Auditability*: Performance indicators developed and disclosed in the GPFR of the GGS would be subject to audit. The audit mandate across jurisdictions varies and is generally embodied in legislation. In addition, the risk is that measures are included on the basis that they are easy to measure and therefore audit – which may not be the most effective way of measuring whether outcomes are being achieved for the community.

- *Comparability*: A report prepared annually by the (Australian Government) Productivity Commission called the Report on Government Services (ROGS) already compares different jurisdictions' service delivery efficiency and effectiveness across a range of services. If comparability among jurisdictions was one of the objectives of Exposure Draft142, experience with ROGS indicates that differing service delivery models and structures, as well as geographic and demographic considerations, pose significant impediments to the development and agreement of indicators that provide fair and comparable information across jurisdictions. Working groups that have been established to support the ROGS development process have endeavored for some years (and continue to strive) to improve the comparability of performance information across jurisdictions.

- *Quality of Current Indicators*: While all jurisdictions in Australia have been attempting to introduce performance measurement systems for government for some years now, varying degrees of success have been achieved. The general consensus is that preparers and auditors tend to favour indicators that are easily measured. These indicators may not necessarily be relevant for assessing whether Government actually made a difference in the community through the provision of the services. For these reasons it is generally accepted – by both Treasuries and government external auditors – that current departmental and whole-of-government indicators are still developing and require significant future refinement to satisfy the principles required in paragraphs 53-56 of Exposure Draft 142. Further development and improvement of existing performance management frameworks such as those described above, would appear to provide greater value for the community than the development of an additional, parallel process.

On balance, as all jurisdictions already report performance at departmental and in a small number of jurisdictions at the GGS level, as well as contribute to the annual ROGS, there is not a strong case for repeating the inclusion of these measures in the financial report on the GGS.

HoTs note that if, another Standard mandates disclosure requirements for performance indicators, the AASB will need to take particular care to avoid any conflict between the new Standard and any existing statutory requirements for reporting performance indicators.

m) The proposals in paragraphs 57 to 62 to require disclosure of:

(i) the original budget, restated if necessary so that it is presented on a basis that aligns with the basis on which the financial statements and notes have been prepared (in accordance with the Standard); and

(ii) an explanation of major variances between the original GGS budget and actual amounts.

HoTs support the requirement for governments to compare outcomes against budget estimates, but do not support mandating whether original or revised budget estimates should be used. This is a matter for individual jurisdictions to determine according to circumstances. HoTs consider that disclosure of either the original or the latest published revised budget information is consistent with the FRC's requirement that outcome statements should be comparable with relevant budget statements.

Revised budget as the comparative

All jurisdictions publish revised budget estimates at various stages during the year, usually contained in a Mid-Year Report or Budget Update and in the Budget Papers for the following year (published around May). Generally, these updates are required by legislation, for example the Australian Government's *Charter of Budget Honesty Act 1998*, Victoria's *Financial Management (Financial Responsibility) Act 2000* or Tasmania's *Financial Management and Audit Act 1990*. The updates contain explanations of changes between the revised budget and the original or previously revised budget.

Although reporting against original budget ensures that explanations of all budget movements are contained in the same publication at the end of the year, reporting only variances since the previous published budget revision allows for the provision of more detailed explanations of movements. Reporting against the most recent published budget allows users to focus on the most recent variances, rather than on movements that may have occurred earlier in the year and that have been previously reported. It is noted that revised Budget information is available in public documents such as the Mid-Year Report or the Budget Papers.

Definition of the revised budget

Revised budgets should be defined as the most recently revised budget that has been published. The revised budget reported in the GGS financial report should be able to be verified against published information.

Definition of the original budget

Paragraph 59 of Exposure Draft 142 defines the original budget as the first budget approved by Parliament in respect of the reporting period. HoTs consider that defining the original budget as the budget first presented to Parliament provides greater understandability and accountability.

The budget presented to Parliament and detailed in the Budget Papers is an easily accessible public source of original budget information. The Budget Papers contain the financial plan of the Executive Government. It is appropriate that the Executive Government is held accountable for that plan. Defining the original budget as the budget presented to Parliament ensures the Executive Government is held accountable for its plan. Any Parliamentary amendments are reflected in revised budgets published regularly.

The budget may include revenue or expenditure measures that are contained within a number of separate pieces of legislation. Most expenditure measures are contained in an appropriation bill. However, revenue measures are usually contained in separate legislation. While appropriation bills are generally passed by Parliament, it is possible that other measures are not passed or are passed at various points in time. In such circumstances, the user would need to be aware of the subsequent changes and the reports or other sources detailing the original budget actually approved by Parliament.

Explanation of variances

Some jurisdictions currently report against original budget as part of their budget outcome statements. However, other jurisdictions report against the most recently published revised budget. Although reporting against original budget ensures that explanations of all budget movements are contained in the same publication at the end of the year, reporting only those movements since the previous published budget revision allows for the provision of more detailed explanations of movements. HoTs considers that both approaches have advantages and that it should be discretionary as to whether the original or most recent revised budget is included in the GGS outcomes statement.

HoTs do not support the inclusion of a requirement for explanation of variances between budget and outcomes in an Australian Accounting Standard. Explanation of variances between budget and outcomes is considered to be management information, which does not generally form part of the GPFR. Explanations of variances can be compared to statements by company directors in the private sector, which are not subject to audit.

HoTs therefore recommend that the Standard should make it clear that explanations of variances are management information and not subject to audit.

Extent of budget disclosures

The provisions of the Exposure Draft could be interpreted as requiring disclosure of budget estimates in the notes to the financial statements. HoTs is strongly of the view that the Standard should clearly specify that budget information is required to be disclosed for the Operating Statement, Balance Sheet and Cash Flow Statement only. Detailed classifications of budget estimates by nature, such as generally contained in notes to financial statements, are not relevant at the GGS level and, in some jurisdictions, not available. Disclosure of budget information in the notes to the financial statements should be at the discretion of each jurisdiction.

Alignment of presentation format

HoTs support the requirement to disclose budget information in the GGS financial report in a format that aligns and is directly comparable with the financial statements.

n) **The proposals in paragraphs 63 to 67 relating to transitional requirements. In particular, the Board is interested in assessments of the costs and benefits of the approach proposed, compared with alternative approaches, including remaining silent in the Standard about transitional requirements, and thereby effectively requiring AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors to operate in its own right**

HoTs support these proposals.

o) **The illustrated acceptable format for the financial statements and notes related to convergence differences in Appendix B. The Board is particularly interested in comments on:**

(i) the columnar approach illustrated for the Balance Sheet and Operating Statement. In addition to any criticisms of the columnar approach, respondents are invited to provide an alternative that is consistent with the Exposure Draft's proposals for the Board's consideration; and

(ii) whether the illustration provides guidance that is helpful in implementing the proposals in the Exposure Draft, particularly those that adopt the requirements in AASB 101 as effectively amended by the proposals

HoTs consider that the proposed columnar format illustrated in Appendix B of the Exposure Draft to be an extremely unwieldy and impractical presentation that will seriously impair the usefulness of government general purpose financial reports. This unnecessary complexity will be exacerbated when comparatives to the previous years estimates, the current budget years estimates and the three forward year estimates are included in the financial statements.

Presenting a budget based on the columnar approach would result in 20 columns across the page. It is preferable that the budget presentation adopted in the Budget Papers is consistent with the format used for financial reporting. Adopting the columnar format as illustrated for financial reports would make it impossible to use the same format for presentation of the budget in the Budget Papers.

The proposal in paragraph 62 of the Exposure Draft to disclose budget information on a separate page is not considered to be a suitable alternative. Reporting of the outcome against the budget is a key accountability requirement for GGS financial reporting and the presentation of financial reports should facilitate the comparison in a form that is readily understandable by users. Similar difficulties arise when historical information is presented for a number of previous years for trend analysis.

HoTs recommended approach to treatment of convergence differences (outlined at point (d) above) allows for significant improvements to be made to the format of the financial statements.

HoTs consider that the column shown in Appendix B to Exposure Draft 142 for convergence differences should be removed. A reconciliation to ABS GFS financial aggregates would be provided in the notes to the financial statements. Removing the column for convergence differences will simplify the statement presentation and shift the focus of the statement to the key results, rather than the convergence differences.

An example of HoTs preferred alternative format is at Attachment B.

HoTs therefore recommend the inclusion of a single-column format in the Standard as the endorsed format. In the absence of such guidance within the Standard, HoTs seek explicit confirmation from the Board that the alternative presentation at Attachment B is acceptable.

p) **Whether it is appropriate for the Standard to cross-reference to GFSM 2001, given that GFSM 2001 is not prepared by the AASB and that there is a need for the AASB to consider whether amendments to the Standard are necessary each time GFSM 2001 is amended. The Board is also interested in comments on whether instead of GFSM 2001 the Standard should cross-reference to the GFS Manual published by the Australian Bureau of Statistics (ABS)**

HoTs consider that the ABS fulfils a similar role in relation to GFS that the AASB plays for GAAP. The International Accounting Standards Board (IASB) sets basic accounting standards that are amended or made law by the AASB.

HoTs have consistently argued for ABS interpretations of GFS to be used, as it is consistent with the IMF interpretation, whilst making allowances for the Australian context.

In place of applying IMF interpretations of GFS, HoTs recommend that reference should be made to "ABS interpretations of GFS", defining this term in the definition section as meaning "the publication of the ABS known as *Government Finance Statistics, Australia: Concepts, Sources and Methods*, as updated from time to time".

This will ensure that the reference is consistent with the Australian context and remove the issue of the reference being out of date in the instance where the ABS publication is updated. The rationale for applying "ABS interpretations of GFS" is:

- Section 12 of the Australian Government's *Charter of Budget Honesty Act 1998* requires the preparation of the budget economic and fiscal outlook report based on the concepts and classifications set out in the ABS publication known as *Government Finance Statistics, Australia: Concepts, Sources and Methods* (an updated version was released on 2 September 2005).

  Whilst the *Charter of Budget Honesty Act 1998* only applies to Australian Government reporting, the Act will supersede a Standard where requirements are inconsistent.

- The ABS GFS Framework refines the necessarily generic requirements of the IMF GFS Framework, into more specific and more relevant requirements for the Australian context. This methodology is similar to that applied by the AASB in issuing AEIFRS as an adaptation of IFRS. As with AEIFRS, such an approach contributes to ensuring a reporting framework better suited to the Australian context.

- There is no compelling reason for preferring IMF interpretations to those of the ABS. Both the IMF and ABS are independent, the *Australian Bureau of Statistics Act 1975* establishes the ABS as an independent statutory authority. The IMF is no more independent. However, the ability of preparers and auditors to effectively communicate with the ABS exceeds that of communicating with the IMF. Australia is one of many nations who hold membership with the IMF. In contrast, the Commonwealth, States and Territories continually interact with the ABS, as the major source of information for the ABS, and the major consumer of ABS information.

Exposure Draft 142 provides no sound reasons or reasoning for preferring IMF to ABS interpretations of GFS. In the absence of such justification, and given the discussion above, HoTs recommend that ABS interpretations of GFS be used.

HoTs acknowledge that the ABS would need to make clear that the IMF's GFS principles and concepts have been adopted and would need to clearly specify any additional guidance provided for Australian conditions, equivalent to the "Aus paragraphs" contained in AEIFRS. Such clarification would be needed before a Standard could be issued.

q) **Whether there are any aspects of GFSM 2001 that you consider should be prohibited from forming part of the basis upon which the GGS's financial report is prepared**

HoTs do not consider that any aspects of GFS should be excluded from the basis of preparing a harmonised GGS financial report, except to the extent where, as outlined above, GAAP treatments are considered to be the conceptually preferred approach.

r) **Whether, overall, the proposals result in financial reports that are useful to users.**

HoTs commend the considerable progress that has been made by the AASB to date in resolving a number of major conceptual and technical issues in the development of the Exposure Draft. However, there is a number of significant issues remaining to be resolved by the AASB, as outlined above, before the outcome of its Harmonisation Project will meet the needs of users or the expectations of the FRC. In order to progress this high priority Project, the AASB is encouraged to undertake a major review of the Exposure Draft in light of HoTs comments, and to issue a new Exposure Draft for stakeholder comment. HoTs would be pleased to provide the AASB with any additional assistance that may be required to support the proposed rework of the Exposure Draft.

Other comments

The AASB may wish to consider making an explicit statement in the proposed standard allowing the preparers of the primary statements to use individual line items which reflect their particular circumstances whilst requiring the sub-totals to be disclosed in accordance with the proposed Standard.

HoTs also note that, whilst the majority of convergence differences have been identified through the harmonisation project, Exposure Draft 142 makes no provision for resolving convergence differences that may be identified after the Standard is released.

HoTs therefore recommend the AASB considers establishing a sub-committee of the AASB, with responsibility for resolving any convergence differences identified after the Standard is released. This sub-committee would need to comprise both GFS and GAAP experts, and have the authority to eliminate convergence differences as they emerge, through issuing the equivalents of Urgent Issues Group consensus views. It is noted that this issue was included in the consultation papers issued for the Project Advisory Panel's consideration. Nevertheless, HoTs recommends that the Standard should acknowledge the role that this sub-committee would undertake.

HoTs recommend that the AASB give priority to issuing an Exposure Draft for financial reporting of the whole-of-government, incorporating the PNFC and the PFC sectors. This is a central issue for comprehensive year-end reporting, and would ensure appropriate Australian Accounting Standards are in place to allow both the GGS and whole-of-government GPFR to be prepared on the same basis and at the same time.

ATTACHMENT A

HARMONISATION OF GOVERNMENT FINANCE STATISTICS AND GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

DEFINITION OF THE REPORTING ENTITY

DON CHALLEN AND CRAIG JEFFERY *

DEPARTMENT *OF* TREASURY *AND* FINANCE, TASMANIA

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**The opinions expressed are those of the authors and are not to be associated with their employer. This Paper draws on material prepared for and by the Heads of Treasuries Accounting and Reporting Advisory Committee.*

Introduction

Harmonisation between Generally Accepted Accounting Principles (GAAP), applicable to the public sector, and Government Finance Statistics (GFS) is the highest priority for Australian public sector reporting. This Paper addresses the question of the reporting entity in a harmonised GFS/GAAP framework and whether the GFS General Government Sector (GGS) meets the criteria for the general purpose reporting entity.

In December 2002, the Financial Reporting Council issued a strategic direction under section 225(2)(d) of the *Australian Securities and Investments Commission Act 2001* that requires the Australian Accounting Standards Board (AASB) to pursue the harmonisation of GFS and Australian Accounting Standards (AAS) for public sector reporting.

The Australian Government, State and Territory Heads of Treasuries have expressed the view that, for effective convergence to be achieved and for the outcomes to comply with the Financial Reporting Council's strategic direction, it is essential that the converged standard requires general purpose financial reports for the GGS.

Background

Good financial reporting is fundamental to delivering effective governance and accountability within the public sector.

The fundamental differences in the operating environments of for-profit businesses and public sector entities mean that many accounting ideas and practices developed for the for-profit sector are inappropriate for the public sector. By uncritically applying for-profit entity concepts to the public sector, current Australian GAAP does not adequately reflect the accountabilities of the public sector. One result is that comparability of financial performance information at a government level is extremely poor, and especially so by comparison with that which currently exists in the for-profit sector. The GAAP framework is totally inadequate in terms of international public sector comparability.

In Australia, all jurisdictions report outcomes based on two frameworks, GFS and GAAP, causing considerable confusion for financial report users. In consequence, the headline presentations of budgets are not comparable across Australia's jurisdictions. In terms of international comparability for the public sector, GFS, rather than Australian GAAP, provides a much more sound basis of comparison.

Harmonisation of the GFS and GAAP reporting frameworks will increase the transparency and accountability of governments by removing the confusion associated with the publication of two sets of financial statements.

Considerable progress has been made in resolving the conceptual and technical issues in the development of a harmonised GFS/GAAP standard. The Australian Heads of Treasuries has been a major contributor to this development through a Working Group of its Accounting and Reporting Advisory Committee (HoTARAC) which, in addition to Australian Government, State and Territory Treasury and Finance officers, has included representatives of the AASB and the Australian Bureau of Statistics (ABS). However, one of the more difficult conceptual issues remaining to be resolved is the definition of the reporting entity at the level which GFS classifies as General Government.

Objectives of Financial Reporting

Statement of Accounting Concepts SAC 2 *Objective of General Purpose Financial Reporting* states that general purpose financial reporting is focused on providing information to meet the common information needs of users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their particular information needs. These users must therefore rely on the information communicated to them by the reporting entity.

General purpose financial reporting is a means of communicating relevant, reliable and comparable information about a reporting entity to users. The objective of financial reporting is therefore based on the information needs of users, with those needs depending on the specific activities of the reporting entity and the type of decisions that users are making. SAC 2 notes that members of the community make resource allocation decisions in respect of government reporting entities, by making reasoned choices between alternative uses of resources. For example, investors decide whether to invest in an entity; creditors decide whether to lend resources to an entity; governments and Parliaments decide, on behalf of constituents, whether to fund particular programs and taxpayers decide who should represent them in government.

The Public Sector Committee of the International Federation of Accountants (IFAC PSC) in Study 8 *The Government Financial Reporting Entity* noted that governments are reporting entities and should be required to prepare general purpose financial reports because:

- they command significant resources;
- the use of those resources can have a significant impact on the community; and
- there is a separation between management and ownership of those resources.

IFAC PSC Study 1 *Financial Reporting By National Governments* considered that financial reporting should demonstrate the accountability of the government for the financial affairs and resources entrusted to it, and provide information useful for decision making by:

- assessing the economic impact of the government on the economy;
- indicating whether resources were obtained and used in accordance with the Budget;
- providing information about the sources, allocation, and uses of financial resources;
- providing information about how the government financed its activities and met its cash requirements;
- providing information that is useful in evaluating the government's ability to finance its activities and to meet its liabilities and commitments;
- providing information about the financial position of the government and changes in the government's financial position; and
- providing information useful in evaluating the financial performance of the government in its use of resources.

Qualitative Characteristics of Financial Reporting

The quality of the information provided in financial reports determines the usefulness of those reports to users. The users of government financial reports include Parliament and its oversight committees, the government and government agencies, external monitoring parties such as credit rating agencies, investors and creditors and the public and its special interest groups. Attachment 1 provides detail on the users and uses of government financial reports.

In relation to the presentation of financial information, Statement of Accounting Concepts SAC 3 *Qualitative Characteristics of Financial Information* notes that general purpose financial reports shall be presented in a manner which satisfies the concepts of comparability, understandability, relevance, reliability and timeliness.

In relation to comparability, the users of financial reports need confidence that information is consistent over time and is comparable with other government entities (at a point in time and over time). This implies that general purpose financial reports should be consistently presented by a government (both consistent over time and with other key government reports, such as budgets), and that the reports are comparable with other jurisdictions.

Understandability means that information is understandable, clear and precise. Information provided in government general purpose financial reports should be comprehensible to users, and should be constructed having regard to the interests of users.

Relevance means that the information assists users in making decisions about the allocation of scarce resources, and which enables users to assess the accountability of financial statement preparers. Relevant information enables users to form judgements about the outcomes of past, present and future events. In order for government general purpose financial reports to be relevant, there must be a logical relationship between the information provided and user needs, and the information provided must also be reliable and timely.

Reliable information is information that faithfully represents the transactions that it purports to represent, is complete and verifiable and reasonably free from bias and undue error.

Relationship Between Different Forms of Financial Reporting

It is important to recognise the different objectives of alternative forms of government financial reporting.

AAS 31 *Financial Reporting by Governments* provides for the State, Territory and Australian Governments to prepare accrual based whole-of-government general purpose financial statements. Financial reports prepared under AAS 31 are intended to provide users with financial information for making and evaluating decisions about the allocation of government resources and are subject to external audit verification. However, many key users make little use of the government financial reports that are currently produced in accordance with AAS 31. This is because the AAS 31 reports appear a long time after the conclusion of the financial year to which they relate (the average delay is six months) while, for the majority of jurisdictions, the reports are not comparable with the primary budget documents for the relevant year.

Because the collection of entities and activities embraced by the AAS 31 reporting entity is essentially arbitrary, and varies greatly between jurisdictions, AAS 31 reports are not comparable across jurisdictions. For example, among Australian jurisdictions there is a wide spectrum of scope coverage as regards electricity generators, transmitters and retailers, depending on the extent of privatisation undertaken, and differing lines of demarcation as regards bulk water and sewerage provision between the for-profit sector, state and local government. Indeed, AAS 31 reports are so difficult to interpret that in many cases they are virtually useless to users.

GFS is an "accounting framework" for the production of national and government accounts, that allows comparison between jurisdictions and the formation of national aggregates. The GFS system is designed to provide information that enables users to assess developments in the financial performance, financial position and liquidity of the government in a consistent, comparable and systematic manner. The establishment of internationally recognised standards by the International Monetary Fund (IMF) enables GFS information to be used in cross-border analysis of government operations.

GFS specifically provides for governments to report against the GGS and other standardised sectors (Public Non-Financial Corporations, Public Financial Corporations Sector and Total Public Sector). Sectoral classifications in GFS are principles based. In Australia, the arbiter in the application of the GFS standards is the ABS. The reporting entity concept does not apply to GFS reporting, and GFS places no specific emphasis on any individual sector. Preparers and users of GFS reports select the sector that is most appropriate for their particular analytical needs.

The most significant users of government financial reports focus on GFS based reports because:

- international regulatory and reporting agencies prefer to look at standardised data that can be compared to similar units or sectors from other countries;
- credit rating agencies prefer information that eliminates local variations in measurement and presentation;
- national statisticians use GFS-basis data as a key input into the compilation of national accounts; and
- economic and financial analysts are generally more comfortable with the terminology and definitions adopted by GFS.

Because the entities in existence and the activities undertaken in the public sector vary considerably between jurisdictions, the boundaries of the GFS sectors are determined by the principles expressed in the GFS standards. In GFS, the scope of those sectors is consistent across jurisdictions and is generally stable over time within jurisdictions. The core GFS sector, which corresponds to the activities undertaken by, and the entities directly accountable to, the Executive Government, is the GGS. The nature of the GGS is such that the scope of activities, and the classes and nature of the entities it embraces, is very highly comparable across like jurisdictions, such as between national governments or between the Australian States and Territories.

The GGS comprises all government units of the State, Territory and Australian Governments. Government units are entities that carry out the functions of government as their primary activity. Government units have legislative, judicial, or executive authority over other government entities. Government units provide goods and services to the community on a non-market basis, make transfer payments to redistribute income and wealth and finance their activities mainly through taxes and transfers from other sectors. The scope of the GGS conforms with the GFS principle that, generally, all entities funded by budget appropriations must be amalgamated into a single institutional unit. This principle is consistent with using the GGS for determining the scope of the budget sector.

The GFS framework dominates budget reporting for Australian jurisdictions. Consequently, most jurisdictions currently focus on the GGS for the headline presentation of budgets.

Defining the Reporting Entity

Accountability within the public sector is different and much broader than the relatively narrow financial emphasis which dominates the for-profit sector.

The financial reports of for-profit businesses are mainly designed for the needs of users who are interested in trading the equity in financial markets. The financial markets want to know how businesses are going, and how they went. Users employ the outcomes statements of for-profit businesses to forecast future performance and to place valuations on the equity of each business.

However, there is no market for general government equity. As general government equity is not tradeable, it is not appropriate to provide the users of government general purpose financial reports with information that is designed to assist analysts and investors in making equity investment decisions. Government financial reports should be designed to facilitate accountability to the Parliament and to the public for budget outcomes, and enable the Government to make informed decisions about the allocation of resources to achieve its desired policy outcomes. Government financial reports must also assist the markets to assess the impact of government activities on the relevant economy. Budgets summarise the Government's fiscal policy priorities and the primary resource allocations flow from budget reports. GGS reports are important to users because they facilitate an assessment of the economic impact of the Government's fiscal policy initiatives, such as taxation measures or new expansionary outlays, without the impact of those fiscal policy levers being smothered by the additional entities that are consolidated in the AAS 31 reports. Likewise, users that are seeking to gauge the likely impact on monetary policy of an expansionary or contractionary budget, must assess the movement in the GGS, rather than relying on a consolidated whole-of-government financial report which also reflects the trading results of large numbers of non-GGS entities.

There is widespread agreement in the recent accounting literature that governments should be transparent and accountable for their activities and for their budget outcomes. The importance of public sector budgeting is significantly different from the for-profit sector. For-profit businesses are significantly more accountable to users for their performance and financial position, rather than their budget compliance. The requirement for public accountability for budget outcomes, is a fundamental difference between the public sector and the for-profit sector, which needs to be reflected in the definition of the government reporting entity.

It is essential that the public sector reporting framework be based on a sound conceptual model that is appropriate to the public sector context and which supports presentation standards that are relevant to both budget and outcomes reporting.

The differing accountability requirements and processes of the public sector mean that government general purpose financial reports must be interpreted in the context of the unique characteristics of the role of government, as they cannot be interpreted in the same way as the reports of for-profit businesses. The suitability of government general purpose financial reports for rendering accountability to the Parliament and to the public for budget outcomes is of paramount importance.

Government general purpose financial reports must be consistent with the key SAC 3 characteristics of comparability, understandability, relevance, reliability and timeliness. These criteria are interdependent and each is necessary for financial information to meet the needs of users and be clearly understood. The issue of comparability is the fundamental basis of why users want governments to produce financial statements. Comparable information enables valid comparisons to be made over time within each jurisdiction and between other jurisdictions, and requires the use of consistent accounting principles and methods.

The existing duality of government reporting frameworks detracts from the usefulness of the outcomes reports, because it creates uncertainty about the meaning and reliability of the respective information. Budget versus outcomes comparisons are essential for fiscal compliance and accountability purposes.

The accounting standards should provide for government general purpose reports which are comparable between like jurisdictions (both within Australia and internationally), where the outcome statements are directly comparable with the budget statements and which provide the capacity for Auditors-General to issue an unqualified audit certificate to a fully compliant report.

Determining the boundaries of the government general purpose reporting entity is central to the achievement of the objectives of financial reporting. The government reporting entity must be defined so that government outcome statements provide a comprehensive, understandable and comparable overview of the government's activities, which are directly comparable with the relevant budget statements. If the entities, transactions and activities encompassed by government general purpose financial reports are clearly and consistently defined, it will be significantly easier for governments to effectively discharge their accountability obligations.

The nature of the entities, transactions and activities that should be encompassed by government general purpose reports should be based on the objective of financial reporting, which must be determined by reference to the information requirements of users.

The Statements of Accounting Concepts can be used to determine whether the GGS constitutes a reporting entity in its own right. As noted above, SAC 2 defines a reporting entity as an entity with users that are dependent on general purpose financial reports for information which is useful for making and evaluating decisions about the allocation of scarce resources. In addition, IFAC PSC Study 1 notes that the overriding objective of government financial reporting is the disclosure of information for accountability and decision making purposes.

Based on this definition, it is readily apparent that the GGS should be a general purpose reporting entity. As the GGS is the budget sector in most jurisdictions, there are large numbers of key users that are dependent on GGS based general purpose financial reports, particularly in relation to accountability for budget outcomes. Given that the budget sector represents the principal means of government service delivery and income and wealth redistribution, the majority of users are significantly more interested in the financial performance of the GGS, rather than the results of the Total Public Sector.

Defining the government general purpose reporting entity on the basis of entities, transactions and activities which are within the GGS, enables governments to be transparent and accountable for their activities, in a form that is comparable with other jurisdictions.

IFAC PSC Study 8 notes that the budget sector is a relevant basis for determining the boundaries of a government general purpose reporting entity, because users are interested in knowing how efficiently government policies for the allocation of public funds have been delivered. Study 8 also notes that it may be most appropriate for the budget sector (GGS) to be the government reporting entity because those users that are interested in the activities of non-GGS entities can obtain more relevant information from the separate financial reports of those entities.

As the majority of Australian jurisdictions prepare their Budgets primarily for the GGS, there are significant users, including Parliament and its oversight committees, the government, external monitoring parties, investors and the public, who utilise GGS outcome reports. Given that the need for information about the GGS comes from users, the accounting standards should define the GGS as a general purpose reporting entity. GGS based general purpose financial reports will focus users on those activities for which governments are directly responsible. Additionally, public accountability will be significantly improved if government outcomes reports are directly comparable with budget statements, and are subject to external audit certification.

Difficulties Associated with the Concept of Control

The applicability of the concept of control to the public sector also requires consideration. As noted above, it is essential that the public sector reporting framework be based on a conceptual model that is appropriate to the unique characteristics of the public sector.

In this regard, the concept of control, as it applies in the for-profit sector, is not readily applicable to the public sector, to determine a reporting entity that is relevant to the activities of the Executive Government. This is because, if the GGS was to be expanded on the basis of the conventional for-profit sector control tests, in most jurisdictions there would be little difference between a general purpose financial report for the expanded GGS entity and a fully consolidated whole-of-government general purpose financial report. However, as users are interested in knowing how effectively government policies for the allocation of public funds have been delivered, the GGS (budget sector) is significantly more relevant as the government general purpose reporting entity.

Other difficulties associated with the use of control, as the determinant of the reporting entity, include the fact that governments have a wide potential range of control. Governments have the power to regulate the behaviour of many entities by use, with Parliament's consent, of its legislative powers. While such legislative arrangements govern accountabilities, they also confer rights, functions and powers on public sector entities. Having conferred on them such rights, functions and powers, these entities are put beyond the control of Government and even of Parliament, subject to legislative change. To ensure that the Government's general purpose financial reports only include entities about which it can make resource allocation decisions, the concept of control should not include two main classes of entities.

The first class is those statutory entities (and statutory officers) conducting activities within a regulatory framework established by legislation that are accountable to Parliament, but which have statutory powers that prevent influence by the Executive Government and Parliament, except through a change in the empowering legislation. It is important to distinguish the capacity of Parliament to legislate and influence the financial and operating policies of statutory entities, from the inability of the Executive Government and Ministers to make policy decisions regarding the deployment of the resources of those entities. Statutory entities are not subject to government control in the exercise of their day-to-day activities, and their financial activities should not be aggregated into government general purpose financial reports.

The second class is those PFC and PNFC entities which are created by statute and which operate as government businesses. This class includes State-owned corporations for which there is an Act which authorises the establishment of the Corporation and that limits the capacity of the Executive Government, or Ministers holding shares in trust, to effect changes to the Articles of the Corporation, this being the standard State-owned corporation model in Australia. While control of the Government's ownership interests in government businesses generally vests in the relevant Minister, either as shareholder or through specific shareholder-like responsibilities, the Government's ability to control or influence the operational and strategic decisions of these entities is normally impaired or restricted. Ministers cannot exercise "control" over government businesses (even when the business is operating in accordance with Corporations Law) in the same way that control can be exercised by the shareholders of for-profit sector businesses. The statutory framework, under which government businesses operate, confers specific and limited powers on Ministers and constrains their capacity to influence the Boards of these entities. Entities in the PFC and PNFC sectors are given significant autonomy and vigorously defend their independence. In some cases, recognisable constraints may also in some instances be political in nature. For example, the Australian Government's ability to influence Telstra is subject to constraints due to the interests of minority shareholders and the interest of the public in how communications and other services are delivered.

Consequently, in many instances, Government is constrained from exercising the same degree of influence, or control, over associated entities that a for-profit sector owner would normally be able to apply. Therefore, in respect of the public sector, the concept of "control" needs to be restricted to certain types of control, while the application of the concept still requires substantial judgment. For this reason, the control concept is of limited use in determining the scope of the government reporting entity.

While the Executive Government may be considered to control other public sector entities in a traditional for-profit sector sense, the Executive Government's ability to influence the operational and strategic decisions of associated entities is frequently impaired or restricted. For example, while the Commonwealth Treasurer is able to give specific instructions to the Reserve Bank's Board about its retention of operating surpluses, the Treasurer is not able to direct the Board to increase interest rates or to support the Australian dollar. Entities in the other sectors are given significant autonomy and vigorously defend their independence. In many other cases, similar to the Telsta example above, the ability of the Executive Government to influence associated entities is significantly restricted by the interests of the public or other stakeholders.

The existence of control will depend on the facts in each case. If the control test is correctly applied in the public sector context, the outcome will be a reporting entity which encompasses the activities of Executive Government including departments and agencies under its influence, but excluding statutory entities and the activities of statutory officers within departments and agencies. Consequently, application of the control concept is likely to lead to a definition of the government reporting entity that varies significantly over time within a jurisdiction and varies enormously at any single point in time between jurisdictions. This is inconsistent with the key SAC 3 characteristics of comparability and understandability.

It is inconceivable that correct application of the control test could produce a government general purpose reporting entity that looks remotely like the Total Public Sector for the relevant jurisdiction. This view is based on the fact that no entity exercises "control", in the conventional sense used in the Statements of Accounting Concepts, over PFC and PNFC entities.

Nevertheless, AAS 31 contrives to apply the for-profit sector based control test to require fully consolidated whole-of-government general purpose financial statements. As noted above, there is no specific government entity which exercises control over government businesses and other statutory bodies in the normal sense in which the term "control" is used in the for-profit sector. In addition, many of the consolidated revenues, expenses, assets and liabilities which are contained in the AAS 31 reports are collections of transactions (for instance, the aggregation of general government taxation and grants revenue with revenue from the sale of goods and services from assorted government businesses) which are so heterogeneous as to render many of the ensuing results beyond sensible interpretation. Many of the transactions of government businesses and other statutory entities do not involve government policy or resource allocation decisions and therefore are incidental to disclosures relating to the legislative and fiscal compliance aspects of government accountability.

A New Government Reporting Entity

In order to provide a comprehensive and comparable report on government activities, as required by SAC 3, the entities, transactions and activities encompassed by government general purpose financial reports must be clearly and consistently defined. This will enable governments to effectively discharge their accountability obligations.

For practical reasons, determining the entities, transactions and activities that are included in government general purpose financial reports will require the establishment of detailed rules or guidance in the relevant accounting standards so that consistent decisions can be made. The alternative, as recommended above, is to use a standard definition of the government reporting entity, such as the GGS.

The key point is that there is no realistic alternative to using a standardised boundary approach to define the scope of the government reporting entity. While the standard-setters could start from scratch and specify new criteria, such an approach is questionable when an acceptable, and well understood, set of criteria already exists in the form of the GFS standards. Since there is currently widespread interest in, and use made of, GGS information by users, the GGS is the obvious candidate for the government reporting entity.

It is noted that some commentators have argued that the GGS is not a legal entity and therefore cannot be a reporting entity. This argument is inconsistent with AAS 29 *Financial Reporting by Government Departments*. Departments are not legal entities, but have been required to produce general purpose financial reports, as reporting entities, in accordance with AAS 29 since 1997-98. It appears to be counterintuitive that departments, which are not legal entities but conveniences through which governments undertake groups of activity, meet the definition of reporting entities under AAS 29, while an aggregation of departments, the GGS, is not considered to be a reporting entity.

The GGS consists of entities that fulfil the functions of government as their primary activity. For most jurisdictions, and all Australian jurisdictions, the GGS is an administrative and fiduciary arrangement that is closely aligned with the entities covered by the Parliamentary appropriations bills. Accordingly, the Government, through the appropriation process, has the greatest level of direct control over expenditure in the GGS.

The GGS, together with the other GFS sectoral classifications, is principles based, easily understood, in widespread use and has definitions of the boundaries that are clear and not open to manipulation. The ABS takes sectoral classifications very seriously, as shifts between sectors can severely distort the comparability of financial reports. As a consequence, changes in sectoral classification are only approved by the ABS after extensive consultation based on the presentation of a detailed case that supports any proposed change in classification. Where the proposed change relates to a prior period, the ABS may decide to recast its GFS reports to preserve the integrity of the time series.

Using the GGS to define the reporting entity avoids the need to determine the classification of public sector entities based on control, where significantly more judgement is required.

AASB's Preliminary Approach

At its meetings in May 2004, the AASB discussed the relative merits of alternative approaches to facilitate GGS reporting and decided that the GGS should be regarded as a sector of whole-of-government. The AASB also decided that it should specify whole-of-government general purpose financial reporting requirements that include disclosure of a "partially consolidated" GGS financial report, which can be extracted as a "stand-alone" financial report (but, significantly, not a general purpose financial report).

While this is understood to be a preliminary position, that is intended to enable the AASB's staff to progress the Project, it is of concern that the AASB's preferred approach does not reflect the inadequacies of the concept of control as applied to the public sector and is significantly at odds with the needs of users as outlined in this Paper.

Importantly, as the proposed extract will not be a general purpose financial report, the AASB's preferred approach will not achieve a standard which provides the capacity for Auditors-General to issue an unqualified audit certificate to a GGS report which fully complies with the relevant standards. This is inconsistent with the objective of achieving a standard which will provide a single set of reports for Governments which are auditable, comparable between jurisdictions, and in which the outcome statements are directly comparable with the budget statements published by that Government for the year in question.

Additionally, while the accounting standard to be developed by the AAAB, within the strategic direction set by the Financial Reporting Council, was expected to contribute to leadership thinking at the international level, it is considered that a standard which is not based on GGS general purpose reporting would represent a significant move away from best practice in international public sector reporting.

Conclusion

Good financial reporting is fundamental to overall governance and accountability within the public sector. Increasing the comparability, useability and understandability of government general purpose reports should be the primary drivers of change.

Defining the GGS as a general purpose reporting entity will improve transparency, remove opportunities for Governments to choose how they present their budgets and their outcome financial statements, and improve the quality of the key financial reports by permitting them to be audited. As a corollary, if the key outcome statement is directly comparable with the budget statements, and is subject to audit, there is a strong incentive for Governments to improve the quality of the information contained in the budget statements.

Don Challen is the Secretary of the Department of Treasury and Finance, Tasmania and Chairman of the Heads of Treasuries Accounting and Reporting Advisory Committee. Craig Jeffery is Director, Government Finance and Accounting of the Department of Treasury and Finance, Tasmania and Tasmania's representative on the Heads of Treasuries Accounting and Reporting Advisory Committee.

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Attachment 1

Users and Uses of Government Financial Reports *

Users	Uses
Government: – The Executive (Cabinet) of Commonwealth, State and Territory Governments	– Comparability of government financial performance with other jurisdictions – Track key financial performance indicators – Sustainability of Budget and forward estimates – Financial management – Track policy delivery
Parliament: – Parliamentarians as "electoral representatives" – Parliamentary oversight committees (eg Public Accounts Committees)	– Approval of funding – Stewardship – Government accountability
Government agencies: – Agencies and Departments (service provision agencies, Treasury and Finance, Audit, Others) – Government Authorities and Boards	– Fiduciary – Managerial accountability responsibilities of individual agencies – In more limited cases, in a monitoring role
Regulatory, reporting and rating agencies: – Australian Loan Council – Australian Bureau of Statistics – Commonwealth Grants Commission – Productivity Commission – Credit rating agencies – Other governments as regulators (eg State over Local Government) – International Monetary Fund – the Organisation for Economic Coordination and Development – World Bank – International credit rating agencies	– Comparability of government financial performance with other jurisdictions – Credit risk assessment – Track key financial performance indicators – Projection of economic impacts
Service providers: – Suppliers – Financial Institutions – Finance Providers under Private Financing of Public Infrastructure – Employees and their representatives	– Comparability of government financial performance with other jurisdictions – Credit risk assessment – Viability of their service market/opportunities for additional work
Public: – Taxpayers and other citizens – Media (financial and other commentators) – Industry groups (eg Business Council of Australia, Chamber of Commerce, Australian Council of Trade Unions) – Tertiary bodies and academics	– Comparability of government financial performance with other jurisdictions – General background information source – Research data – Personal impact of public policy

* This table is a modified version of one developed by and included in a Conceptual Paper of the HoTARAC GFS/GAAP Harmonisation Working Group

ATTACHMENT B

General Government Sector - Example Operating Statement 2003-04

Single column format

	Notes	2003-04
		$m
Income from transactions (excluding gains)		
Taxation income		174 826
Sales of Goods and Services		4 380
Interest Income (Other than Swap Interest)		1 304
Dividends		4 199
Other income		2 850
Total		187 559
Expenses from transactions (excluding losses)		
Employee Expenses		21 144
Suppliers Expenses		14 244
Other Expenses		7 732
Depreciation and amortisation		3 747
Interest Expense		4 211
Other Borrowing Expenses		31
Grants and Transfers		130 143
Total		181 252
NET OPERATING BALANCE		6 306
Other economic flows - Gains/(losses)		
Swap Interest		335
Net actuarial gains/(losses) on superannuation defined benefit plans		....
Net gain on equity investments in unconsolidated subsidiaries measured at proportional share of net assets/(liabilities)		....
Net gain / (loss) from disposal of physical assets		1 497
Net foreign exchange gains		599
Other non-taxation income		1 157
Net gain on other financial assets or liabilities at fair value through operating result		494
Employees		899
Benefits and grants		(1 417)
Increase in provision for doubtful debts		(4 828)
Other non-taxation expenses		(410)
Total		(1 674)
NET OPERATING RESULT		4 633
Other economic flows - Other non-owner movements in equity		
Gain/(loss) on revaluation of properties		2 735
Equity injections/withdrawals		(3)
Total		2 732
COMPREHENSIVE RESULT		7 365
KEY FISCAL AGGREGATES		
NET OPERATING BALANCE	1	6 306
Net acquisition of non-financial assets	2	724
NET LENDING /BORROWING	3	7 030

Convergence differences have not been presented on the face of the statements on the basis that full harmonisation will be achieved

ATTACHMENT B

General Government Sector - Example Operating Statement 2003-04

Single column format

	2003-04
Note 1	
RECONCILIATION BETWEEN GAAP AND GFS - CONVERGENCE DIFFERENCES	
Net operating balance	6,306
GAAP-GFS convergence differences	
Goods and Services Tax (Net)	855
Defence Weapons Investment	-2,040
Defence Weapons Depreciation	2,104
Total GAAP-GFS convergence differences	919
GFS NET OPERATING BALANCE	7,225
Note 2	
NET ACQUISITION OF NON-FINANCIAL ASSETS	
Purchase of non-financial assets	2,395
Sale of non-financial assets	-602
Less depreciation	-1,643
Change in inventories	780
Other movements in non-financial assets	-206
Net acquisition of non-financial assets	724
Note 3	
RECONCILIATION BETWEEN GAAP AND GFS - CONVERGENCE DIFFERENCES	
Net lending/borrowing	7,030
Total GAAP-GFS convergence differences	919
GFS NET LENDING /BORROWING	7,949

ATTACHMENT B

General Government Sector - Example Balance Sheet 2003-04

Single column format

	Notes	2003-04 $m
Assets		
Financial assets		
Cash and deposits		1 591
Other accounts receivable		28 663
Securities other than deposits		40 484
Shares and other equity		417
Total		71 155
Non-financial assets		
Inventories		4 832
Land and buildings (excluding heritage)		19 347
Infrastructure		38 867
Heritage and cultural assets		6 442
Intangibles		1 550
Other non-financial		1 968
Total		73 006
Total assets		**144 161**
Liabilities		
Borrowings		6 316
Government securities		55 355
Deposits		364
Accounts payable		2 349
Employees and superannuation liability		96 630
Personal benefits payable		5 662
Subsidies payable		431
Grants payable		8 577
Other provisions		10 683
Total liabilities		**186 368**
NET ASSETS		**(42 207)**
Equity		
Accumulated funds		(77 509)
Other reserves		35 302
Total equity		**(42 207)**
KEY FISCAL AGGREGATES		
Net Assets		(42 207)
NET WORTH	**4**	**(42 207)**
Net financial worth		
Total financial assets		71 155
Total liabilities		186 368
NET FINANCIAL WORTH		**(115 213)**

Convergence differences have not been presented on the face of the statements on the basis that full harmonisation will be achieved.

ATTACHMENT B

General Government Sector - Example Balance Sheet 2003-04

Single column format

	2003-04
	$m
Note 4	
RECONCILIATION BETWEEN GAAP AND GFS - CONVERGENCE DIFFERENCES	
Net Assets	(42 207)
Convergence Differences	
Assets	
Telstra	32 787
Defence weapons	(30 745)
GST receivable	1 877
Provision for bad and doubtful debts	7 076
International Development Association contributions	4 357
Liabilities	
GST refund provision	238
Government securities	2 089
Department of Family and Community Services contingent liability (one-off)	(94)
Total convergence differences	13 119
GFS Net Worth	(29 088)

ATTACHMENT B

General Government Sector - Example Cash Flow Statement 2003-04

Single column format

	Notes	2003-04
		$m
Cash Flows from Operating Activities		
Cash received		
Taxes Received		172 177
Receipts from Sales of Goods and Services		4 488
GST Input Tax Credits		2 462
Interest Received		1 056
Dividends		3 223
Other Receipts		2 756
Total		186 162
Cash paid		
Compensation of employees		(17 928)
Payments for Goods and Services		(17 564)
Grants and Subsidies Paid		(127 565)
Interest Paid		(4 322)
GST Payments to taxation authorities		(89)
Other Payments		(6 996)
Total		(174 464)
Net cash flows from operating activities		**11 698**
Cash flows from investing activities		
Non-financial assets		
Cash received		
Sales of Non-Financial Assets		853
Cash paid		
Purchases of Non-Financial Assets		(4 897)
Net cash from non-financial investing activities		(4 044)
Financial assets (liquidity purposes)		
Cash received		
Other net investing cash received		281
Cash paid		
Other net investing cash paid		(3 353)
Net cash from financial investing activities		(3 072)
Financial assets (policy purposes)		
Cash received		
Proceeds from sales of financial assets		376
Cash paid		
Net loans, advances and HECS		(605)
Net cash from financial investing activities		(229)
Net cash flows from investing activities		**(7 345)**
Cash flows from financing activities		
Cash received		
Swap interest		1 931
Other financing		71
Cash paid		
Swap interest		(1 515)
Net repayment of borrowing		(2 458)
Other financing		(3 128)
Net cash flows from financing activities		**(5 099)**

NET INCREASE/(DECREASE) IN CASH HELD		(747)
Cash and cash equivalents at beginning of period		2 338
Cash and cash equivalents at end of period		1 591
Net Increase/(Decrease) in Cash and Cash Equivalents		(747)

GFS KEY FISCAL AGGREGATES

Net cash from Operating activities		11 698
Net cash from investing activities in non-financial assets		(4 044)
Net cash flow from operating activities and investments in non financial assets		7 654
SURPLUS/(DEFICIT)	5	7 654

Convergence differences have not been presented on the face of the statements on the basis that full harmonisation will be achieved.

ATTACHMENT B

General Government Sector - Example Cash Flow Statement 2003-04

Single column format

	2003-04
	$m
Note 5 CONVERGENCE DIFFERENCES - Net cash flow from operating activities and investments in non financial assets	
Net cash flow from operating activities and investments in non financial assets	7 654
Operating cash received	
Cash flows treated as financing under GFS	(23)
Operating cash payments	
Cash flows treated as financing under GFS	219
Cash flows treated as investing in financial assets under GFS (IDA)	223
Investing in non-financial assets	
Cash flows treated as investing in financial assets under GFS (Defence Weapons)	(2 226)
Cash flows treated as operating under GFS (Defence Platforms)	2 194
Finance lease and similar arrangements	(5)
Adjustments to GAAP cash flow from operating activities and investments in non-financial assets	383
SURPLUS/(DEFICIT)	8 036

Appendix 2

Preferred Options for Convergence Differences

Convergence Differences with General Application

Provision for Doubtful Debts

Under generally accepted accounting principles (GAAP) there is recognition of the reduction in future economic benefits arising from bad and doubtful debts. Under GAAP bad and doubtful debts are treated as an expense and there is a reduction in receivables (contra-asset). These transactions are based upon a reasonable estimate of the likely difference between the carrying value of the asset receivable and the amount expected to be collected. This reflects the reduction in future economic benefits attributable to that asset.

Provisions for bad and doubtful debts are not recognised in Government Finance Statistics (GFS) as they are viewed as an accounting entry that is not based on an economic event. The Australian Government currently departs from this approach in favour of GAAP in its current budget and budget outcome presentation. It is the view of the Government that without such provisions in the balance sheet it would overstate the value of government assets and would appear to be inconsistent with the GFS principle of market valuation.

The most conceptually sound approach is to mandate **GAAP,** so that a provision for bad and doubtful debts is included in the balance sheet to reflect the extent of receivables' impairment (the face value of the receivable less the provision will give the estimated recoverable amount of the receivable). This is the current Budget treatment.

Distributions to owners

Under GAAP, the treatment of dividends does not change depending on their funding source. That is, there is consistent treatment regardless of whether the dividend is from within the GGS or paid as a result of the sale of non-financial assets. However, the concept of "return of equity" is not well defined in the public sector, where many wholly owned government businesses do not issue shares. It would be appropriate for a standard on GGS reporting to provide guidance on the concept of return on equity.

GFS considers the underlying source of the dividend - surpluses, retained surpluses, or capital restructuring. Proceeds from the sale of non-financial assets would be treated as returns of equity and not dividend revenue.

The preferred position is that ED 142 provides guidance on returns of equity in a public sector environment. Such guidance should be based upon **GFS** principles.

Convergence Differences Applicable to the Australian Government Only

Defence Weapons

Under GAAP, destructive weapons are treated as an asset and capitalised on acquisition. Items are then depreciated as consumed (over their useful lives), written off when destroyed (or consumed), and / or recognise a profit or loss on disposal.

GFS treats all destructive weapons as non-productive assets. Acquisition costs are expensed in the year of acquisition, on the basis that these are non-productive items and assuming that consumption takes place in that year. The GFS Balance Sheet therefore excludes destructive weapons with a resultant reduction in GFS net worth. Profits on sale of previously expensed defence weapons would be reflected in the Statement of Other Economic Flows, with the items marked to market prior to sale.

The most conceptually sound approach is to mandate **GAAP,** so that defence weapons and weapons platforms will be recognised as assets and then depreciated over their useful life.

Subscriptions to the International Development Association (IDA)/Asian Development Fund (ADF)

The subscriptions provide future economic benefits given that they are able to be refunded to the contributing country (the non-refundable component does not provide future economic benefits). These subscriptions are similar to Australia's Special Drawing Rights with the IMF and there should not be an inconsistent treatment across these items.

The portion of Australia's subscriptions to the IDA and the ADF that are refundable (around 80%) should be treated as an asset with the remainder being treated as a grant expense (around 20%). This treatment is consistent with **GFS** and is the one adopted in the Budget.

Currency on issue

The difference between the face value of minted coins and their cost of production should be treated as revenue. The Australian Government has no legal liability to repay the value of the coins on issue and thus a liability should not be recognised. Therefore, consistent with the principles of **GAAP** and current budget treatment, revenue and no liability should be recognised.

IMF Special Drawing Rights (SDRs)

Australia pays interest on its cumulative allocation of SDRs. By accepting the allocation, Australia has entered into a commitment where it must transfer economic value to another party with certainty. As this interest charge is unavoidable, the allocation of SDRs must also be recorded as a liability.

The most conceptually sound approach is to mandate **GAAP.** SDRs should be treated as a liability. This is the current Budget treatment and is consistent with **GAAP.**