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26 October 2005

Prof. D. Boymal
Chairman, AASB
PO Box 204
Collins Street West
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Dear Professor Boymal

ED142 – Financial Reporting of the GGS by Governments

Thank you for sending me a copy of ED142 on 4 August. It is a most important contribution to enhancing public sector financial reporting and a necessary first step in the harmonisation of GAAP and GFS accounting standards.

I am enclosing my comments on the Draft for the Board's consideration. I have had the benefit of studying the Heads of Treasury response to the Draft, which I found to be a most constructive one, and I support most of their views. I apologise for this modestly late response, due to unexpected major surgery three weeks ago. I am sending my comments to you both as a member of the Project Advisory Panel and as an interested academic.

With my best wishes for a successful finalisation of the Draft.

Yours sincerely

Allan Barton



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Mr Robert Keays,
AASB
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31 October 2005

Dear Robert,

ED142 - Financial Reporting of the GAS by Governments

On re-reading my Comments on ED142 over the weekend, I noticed a few typos and other minor errors in my Comments sent to you last week. Would you please destroy the initial copy and replace it with this revision. Sorry for this.

With my best wishes,

Yours sincerely,

Allan Barton.

ED142, Financial Reporting of General Government Sectors by Governments.

**Comments by Professor Allan Barton
The Australian Nation University
Canberra, 24 October 2005**

General Introduction

ED142 is a most constructive proposal and set of proposed standards to recognise and report on the General Government Sector (CGS) through a process of partial consolidation, while still requiring the publication of fully consolidated financial statements for the whole of government (WOG). It is a necessary first step in implementing the Financial Reporting Councils broad strategic direction for harmonisation of the GFS and GAAP financial reporting systems having the desirable objective of achieving an AAS for a single set of government financial reports. I note that ED142 represents only phase 1 of the harmonisation project, and that a further 2 phases are still to be undertaken to complete it.

While I strongly support the purpose and most of the recommendations in ED142, one fundamental matter concerns me. Throughout the Draft, GAAP reports are given pre-eminence over the GFS reports¹. I cannot accept the presumed superiority of the GAAP system in the context of the public sector. It is fundamentally designed for the business for profit sector, and its objectives, concepts and standards are designed accordingly. However the nature and methods of government operations are fundamentally different, as para 6 indicates. If they were not so, then there is no compelling justification for having governments and compulsory taxes to fund their operations. All economic activity could be left to the business sector to undertake. US President Abraham Lincoln (1863, V12, p282) pondered on the issue many years ago and he concluded that:

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

The environment of government and the nature of its operations are fundamentally different to those of the business sector, and accounting information systems must be designed to suit these characteristics if they are to provide useful information to the government and its managers (i.e. the public service), parliament and citizens. Useful information is that which satisfies the requirements of relevance, reliability, comparability and understandability as specified in SAC3 1990. The environment and nature of government activities are explained in standard economic texts such as Stiglitz (2000)² and are summarised Barton (2003). GAAP are designed to suit the financial information needs of the business sector whereas the GFS system is specifically designed by the IMF to provide information about the macroeconomic activities of the GGS and of the whole economy, as the background information in the Preface (pp10-11) and para 34 acknowledge. None of this information is provided under GAAP.

In my opinion, much of the information reported under GAAP for the GGS has severe limitations in terms of the SAC3 characteristics of useful information. GAAP has been applied to the GGS on the assumption of sector neutrality of accounting standards. But this assumption has not been adequately justified in terms of the fundamental characteristics of government activities, and I believe it cannot be so justified. Rather, its justification is primarily an ideological one, and GAAP have been unsoundly applied to the public sector. The sector neutrality assumption has been examined in Barton (1999, 2002) Carnegie and Wolnizer (2002), and Newberry (2001).

A prime example of the inapplicability of GAAP concepts to the public sector concerns the concept of control as applied in SAC1 (1990) to determining the boundaries of the accounting entity, which is the subject matter of ED142. It is based on the corporate model and was used until recently to reject recognition of the GGS as a valid accounting and reporting entity. Strong reasons for its recognition had been advanced in several articles by Challen and Jeffery (2003, 2005) and submissions to the Board by HOTARAC. The irrelevance of the corporate concept of control for defining the boundaries of the GGS is graphically illustrated with respect to the court system. Courts are established by governments and (largely) funded by them. Judges are appointed by government, their staff are members of the public service and their assets are owned by the government. On the basis of these facts, courts would be controlled by government, using the corporate model. Yet a fundamental principle of British law for many centuries, and which was adopted in Australia and enshrined in the Constitution (1901), concerns the separation of powers between the legislature and the judiciary, i.e. courts are independent of government in all legal decision making. As well, the independence of the judiciary is a fundamental tenet of parliamentary democracy.

Likewise, most government agencies established by statute e.g. the Australian Bureau of Statistics, Reserve Bank, are guaranteed their independence from government with respect to policy making and management. The concept of control for statutory agencies is the opposite of that for subsidiary companies where the senior management is responsible to the parent company.

Hence for the above reasons, I believe that the GFS system is the appropriate one for government rather than GAAP. It provides useful information which is relevant for the information needs of government, and which can satisfy the reliability, comparability and understandability requirements. However it suffers from a few problems such as the expensing of all expenditures on military equipment, and it needs enhancement for its application at the micro level of government resource management.

COMMENTS ON SPECIFIC MATTERS IN ED142

a.b. GGS as a reporting entity (para. 5)

- . I agree.

c. Compliance with AAS and GFSM 2001 (paras. 8-12)

- . Yes, but my preference is to reverse the priorities given to the two systems and to rank GFS ahead of AAS. Where there are gaps in GFS, then AAS can be used so long as they are not in conflict with GFS principles.
- . I do not support averaging actuarial gains and losses in defined benefit superannuation schemes over time using a "corridor approach"; rather they should be recognized in full as "other economic flows" in the GFS system or in full in GAAP comprehensive income.

d. Compliance with GFSM 2001 (paras. 13-17)

- . Yes, although my preference is to prescribe the ABS GFS Manual in place of the GFSM one. The ABS Manual has been adapted in a few places to suit the local environment. I understand that the variations between the Manuals are not major ones.
- . I prefer reconciliations between GFS and GAAP to be provided in notes to the financial reports. It is important to keep the formats of the reports simple to enhance their readability and understandability. The formats for the Operating Statement and the Balance Sheet illustrated in Appendix B are too complex.

e. Investment in non-consolidated controlled entities (paras. 19-23)

- . I agree.

f. Format and content of the balance sheet (paras. 26-31)

- . The format showing Financial Assets and Non-Financial Assets, Liabilities and Equity/Net Worth is appropriate. However I believe the presentation of two sets of balance sheet figures will lead to confusion, lack of understanding and lack of trust in government generally. This can scarcely satisfy the need for transparency and accountability of governments and use of the conflicting information for decision making. Which figures are to be believed? Both sets of figures cannot satisfy the SAC3 requirements for useful information.
- . Although the number of divergences between the GFS and GAAP accounts in Appendix B is not large, the divergences shown in the budget reports include every group of items and some of them are relatively substantial. In fact, the only item which has the same measure in each system is the cash at bank! I attach a summary of GFS and GAAP aggregates (Attachment A) taken from the 2005-06 Budget Paper No 1, Statement 9:4-6, and Statement 10:2-4 to illustrate the extent of the different magnitudes reported under each system. Unfortunately I do not have comparative outcome figures to

hand, but I would not expect the overall picture shown by them to differ much from that shown by the budget data.

- . My preference is for only one set of figures to be shown on the face of the balance sheet, with a list of convergence differences shown in a note. This would be easier for users to understand. However my preference would be to show the GFS figures rather than the GAAP figures; for reasons indicated earlier.
- . If both GFS and GAAP figures are to be listed, I prefer the HOTARAC format in which the convergence differences are referenced in the balance sheet to the attached notes.
- . Presentation of two different balance sheets which are to be audited, is likely to place the Auditor General in a difficult situation in attesting to the truth and fairness of balance sheets for the same entity and balance date (notwithstanding the qualifying statement concerning preparation of the reports in accordance with AAS and GFS standards etc). Any major company publishing two sets of very different financial statements would arouse great suspicion in the minds of investors and the public.
- . I endorse use of the title "balance sheet" (or preferably a "statement of assets and liabilities") to the GAAP title of a "statement of financial position". Such a title is grossly misleading in the context of governments. The balance sheet does not show the government's financial position – if it did then the Australian Government should be declared to be bankrupt in the light of its large negative net worth each year. However, it is not bankrupt because the balance sheet (rightly) does not include the most valuable of all assets, viz the sovereign power to tax.

g. Format and content of the operating statement (paras. 32-40)

- . I support use of the title "operating statement" for this report rather than its commercial counterpart of "statement of financial performance" as it is a more accurate title.
- . List of items for disclosure (para. 34). "Transaction" items should be distinguished from "other economic flows" as in the GFS system as the distinction is important for macroeconomic analysis. Transactions involve exchanges of real resources, whereas most "other economic flows" merely involve revaluations of a given stock of resources. These result in a redistribution of existing wealth claims rather than the generation of new additional resources. The proposed measures of net changes in non-financial assets, financial assets and liabilities mix up changes resulting from the two sources.
- . Where GFS and GAAP amounts differ, I prefer the differences to be disclosed in note form, as HOTARAC recommends, rather than on the face of the statement, as a means of keeping the report simple. The 4 column format in

Appendix B is complex and serves to highlight the convergence differences (many of which are classification ones only). It would not be readily understood by most users, and is likely to confuse users. HOTARACs single column format accompanied by convergence differences in notes, and its method of disclosing key variables, is much clearer.

Again, I do not support the preeminence of the GAAP report over the GFS report. Furthermore, the GAAP operating statement suffers from the mix of valuation bases which affect asset consumption charges and recognition of holding gains/losses, and from its failure to specify a capital maintenance concept on which the measure of "comprehensive income" is based. All concepts of income must be related to a capital maintenance concept because income measures a gain in net assets (however defined and measured). The GFS system is based on the concept of physical capital maintenance. Hence holding gains/losses on domestically owned non-financial assets do not form part of income because they do not increase the stock of assets or productive capacity, whereas they can be included in comprehensive income. But such holding gains resulting from inflation causes an additional burden in replacing the assets when required, rather than a gain in wealth and spending ability.

h. Format and content of the cash flow statement (paras. 41-43)

I agree with the proposals.

It is important for policy analysis to distinguish between investing in financial assets for policy reasons and for liquidity management purposes. Movements in liquidity occur over a vast range from day to day (according to flows in tax receipts and expenditures) and determine the need to issue/redeem Treasury Notes. Decisions to invest/disinvest in financial assets are based on longer term considerations.

An important point not addressed in the Draft (rightly so) is that the CFS should be prepared directly from cash transaction data, preferably on a daily basis to facilitate liquidity management, rather than from the elimination of all non-cash items from end-of-year accrual accounts. One can expect CFSs to factually represent the cash flows of the entity on specific classes of items. Yet the CFSs currently published show marked differences in receipts and expenditures on each category of items between the GFS and GAAP statements, as indicated in Attachment A. (The differences are due to classification matters).

i. Note on significant accounting policies (paras. 44-45)

The Notes are sufficiently clear and comprehensive. They clearly distinguish between the GGS and WOG financial reports.

j. Other explanatory notes (paras. 46-48)

I agree. The entities included in the GGS should be identified, and key technical terms defined.

k. Disaggregated information about GAAP and GFS amounts classified on a functional basis in notes (paras. 49-52)

- . I do not support this proposal. I doubt if it is feasible without substantial additional work, it might be difficult to attribute items to specific functions, and I doubt the need for this additional information given the vast amount of budget and outcome information already provided. As well, I don't believe that detailed comparisons of GAAP and GFS items provide useful information.

l. Presentation of performance indicators (paras. 53-56)

- . I agree with the principles stated for the development of performance indicators; however they should not form part of an accounting standard and they are not a part of the harmonization project. The development of performance indicators is a difficult task in view of the problems encountered in measuring outputs and outcomes resulting from the implementation of government policies. These problems arise primarily from the nature of public sector "products". A substantial amount of work is required to advance the development of performance indicators and measure performance.

m. Disclosure of the original budget along with the outcome statements (paras. 57-62)

- . I support the proposal, together with an explanation of the major variances between the two. It should be noted that the variances are normally substantial as Treasury cannot be expected to accurately forecast a mass of future economic events fifteen months in advance. For this reason I would also allow the use of mid-year budgets in place of initial budgets as they are prepared some 9 months later on and the forecasts are more accurate.

n. Transitional requirements (paras. 63-67)

- . I support the proposals, but with some hesitation about the introduction date for the 2006-2007 fiscal year. The lead time may not be adequate.

o. Appendix B financial statements and notes

- . Covered earlier.

p. Cross reference to GFSM 2001

- . I prefer that the reference be to the ABS Manual as it is the IMF one modified to suit the Australian environment. In turn, the reference to the ABS Manual may state that it is based on the IMF one and perhaps list any major differences.

q. Unwanted aspects of GFSM 2001

- . No, as the GFS system is a rigorous and carefully formulated financial measurement system.

r. Usefulness of the financial reports

For the reasons indicated earlier, I believe the GFS financial statements provide useful information for macro-economic policy making, control and accountability. However, I do not believe the GAAP statements are of much use – rather they can be unreliable and misleading in the context of government operations because of serious limitations in their relevance to the GGS.

Attachment A**Comparison of AAS and GFS Budgets 2005 - 2006**

	<i>AAS31</i>	<i>GFS</i>	<i>Difference</i>
<i>Operating Statements</i>			
		<i>\$million</i>	
Total Revenues	217,869	252,511	34,642
Total Expenses	209,074	243,521	34,447
Net Operating Results	\$8,794	\$8,990	\$196
<i>Balance Sheets</i>			
Financial Assets	87,554	130,507	42,953
Non-Financial Assets	75,751	42,397	-33,354
Total Assets	\$163,305	172,904	\$9,599
Liabilities	\$197,885	198,327	\$442
Net Worth	-\$34,579	-\$25,423	\$9,156
<i>Cash Flow Statements</i>			
Cash operating surplus	15,583	12,198	-3,385
Net purchase of assets	14,802	11,547	-3,255
Net debt repayment	1,420	1,291	-129
Net reduction in cash	\$639	\$639	-

Source: Budget Paper No.1, 2005-06, Statement 9:4-6; Statement 10:2-4

FOOTNOTES

1. The history of the development of the System of National Accounts, on which the GFS system is largely based, is worthy of note. National accounting was developed by a famous Australian economic statistician, Colin Clark, who was a colleague in Cambridge University of John Maynard Keynes. Keynes General Theory of Employment, Interest and Money (1936) developed a macroeconomic theory to facilitate management of the economy so as to bring about stable economic growth with full employment and price stability. The national accounting system was largely designed by Clark to provide necessary financial information for these purposes. Clark returned to Australia in 1939 and he prepared the world's first set of national accounts for Australia. The Australian Bureau of Statistics has been regarded as a world leader in national accounting ever since. The System of National Accounts was later refined by Professor Richard Stone, Professor of Accounting at Cambridge University during the 1970s and 1980s and a protégé of Keynes. Stone was awarded the Nobel Prize in Economics in 1984 largely for his national accounting work.
2. Stiglitz is a world famous economist, currently a professor at Columbia University in New York. Formerly he was Chairman of the Council of Economic Advisers under President Clinton, and Chief Economist of the World Bank. He was awarded the Nobel Prize for Economics in 2001. His public economics work is partly based on the theory of public goods as developed by Paul Samuelson of the Massachusetts Institute of Technology. Samuelson was also awarded the Nobel Prize in Economics.

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