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Evolution in the Public Sector – Auditing, Corporate Governance, Whole of Government Reporting

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Australian National Audit Office

EVOLUTION IN THE PUBLIC SECTOR

AUDITING

CORPORATE GOVERNANCE

WHOLE OF GOVERNMENT REPORTING

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INTRODUCTION

The theme of this Congress is: ‘Profit from our experience!’. In this session, I would like to discuss our experience (that is, the experience of the Australian National Audit Office - ANAO) in anticipating, as well as responding to, a rapidly changing environment. The focus of my address, given the audience, is mainly on our financial statement auditing. However, I stress that the ANAO’s vision is to add value to public administration, which includes through our performance audits.

I hope this session is not only of general interest but may also be of some assistance whether you are part of the profession involved in auditing or advising on auditing/accounting issues, particularly in relation to the public sector, or you are one of those important clients or stakeholders who are audited or advised on their financial control and reporting environment. There is growing acceptance of the notion of a close working relationship between auditor and client without necessarily undermining the independence of the auditor.

What we have realised, particularly in this environment, is the need to learn from others’ experience. It is important that the private and the public sectors both appreciate the potential of such an approach. But each sector needs to acknowledge that the other has its unique challenges and the solutions that fit best in one sector may not be suitable in the other. Nevertheless, there is increasing scope for such exchanges as public sectors adopt more commercial approaches and many activities are commercialised and some even corporatised. As well, even so called ‘traditional’ public services are being increasingly delivered by the private sector.

To provide some context for my remarks, the ANAO, with a total staff of about 350 (down by just under 300 since 30 June 1992), undertakes the audit of almost all entities owned or controlled by the Commonwealth. Around 60 departmental reporting entities, 180 statutory authorities and other similar bodies and 250 companies were reported on in 1995-96. For all except a small number of these entities (companies which include most government business or trading enterprises), the Commonwealth audit mandate includes performance audits as well as financial audits. We aim to complete about thirty five performance audits each year.

Today there are many additional demands of, and challenges to, auditors. Some of these challenges are long standing; some are very recent. Indeed, a number of our responses are also long standing and maturing but many are quite recent with some being developed only in the last year. Other responses may be further off in time particularly if they require substantial shifts in, for example, the skill base of the ANAO.

This session is directed towards some of those major challenges and responses. It is in four parts. The first is an outline of some of the initiatives being taken to create a more competitive and professional approach in auditing. The second is a complementary discussion of how we are developing a more client service orientation particularly through our new audit products and audit related services. The third addresses the issue of Corporate Governance and its application to the public sector, as well as the role audit can play in the successful implementation of the necessary governance framework. The fourth looks at the introduction of Whole of Government accrual based financial reporting and its implications for audit.

I. CREATING A MORE COMPETITIVE AND PROFESSIONAL APPROACH

Greater involvement of the private sector in public sector activities, including service delivery, even in some areas traditionally regarded as public service, has meant that all public sector managers have had to at least think about possible implications, both direct and indirect, to their own operations. In some cases it might involve direct competition or even replacement through, for example, privatisation or complementary/supplementary private sector activity. The first two approaches generally require government decision; the latter may result from such decisions but are usually made by the managers concerned.

Some such decisions may be just ‘testing the water’; others may be part of transitional policies. But many could simply reflect the outcome of a review or evaluation of cost effectiveness of the service delivery processes. Not surprisingly, therefore, this part of the session is largely concerned with competition, contracting and computing which are often mentioned as part of ‘reinventing government’ or the ‘New Public Management’, as some academics describe the range of public service reforms that have been implemented over recent years in many Western democracies.

Private Sector Involvement In Public Audits

The ANAO has been confronting directly the issue of private sector involvement in public audits in recent years. Just under 30 per cent of our running costs are now applied to payments to contractors (largely explaining our staff decline since 1992). Much of this relates to our using private sector firms, in the main the so-called 'Big 6' accounting firms, as our agents in conducting financial audits. This does not abrogate our responsibility for the opinion given on those financial statements nor from our responsibility to be satisfied that the work of our agents is not just "adequate" but is based on demonstrated good professional practice. Therefore we retain strong project management and oversight of such audits both for our assurance and understanding of the issues, including the personal development of our staff.

The ANAO faces difficult decisions about how to cover particular audit clients. From a cost perspective, it would often be very expensive to maintain in-house the expertise needed to audit such entities, particularly where there is a strong identification and/or relationship with the private sector. That is, where the entities are not part of the recognised core of public sector activity. Perhaps more importantly, from an audit effectiveness viewpoint, it would be very difficult to obtain and maintain the necessary experience to conduct such audits well, with a full knowledge and understanding of the industry in which they operate. Private sector firms with the appropriate connections are often able to call on the necessary expertise and background knowledge nationally and internationally as well as being able to maintain that expertise because of their broader client base in particular areas.

Using the private sector in this way does, moreover, provide us with the opportunity to concentrate our own resources on what we see as our core business. Broadly, this is all entities wholly or mainly budget funded. Here we have our own specialist skills, knowledge, understanding and experience of public sector functions and activities. At the same time, we are providing a better service with private sector firms to the more specialised entities, often with limited or no <u>budget</u> funding, than we could using solely our own resources. Such a strategic approach ensures that we are not only able to provide the Federal Parliament with the necessary assurance about overall public service accountability but we also have the necessary degree of involvement to do so credibly. The issue is basically about achieving the <u>right</u> balance of such involvement to be effective.

Apart from our major financial audit contracts, we routinely employ private sector firms and individuals from a range of professions (including tertiary institutions) to assist in the conduct of financial and performance audits in specialist areas, or in meeting peak workloads, where particular skills might be needed because of the nature of issues and/or activities being covered. The notion is to achieve the best skill mix we can to achieve a cost effective audit outcome.

In a number of areas, including financial auditing and some of the related activities, we have undertaken studies to assess our own approaches against best practice in the private sector. We have also undertaken what might be called “reality testing” of some of our products to ensure, for example, that our recommendations have the support of specialists in relevant areas of the private or public sectors.

It is in these ways we demonstrate our commitment to learn from the collective experience of our peers, particularly in the accounting and auditing profession, and to give other public sector entities that opportunity as well. We are also aware that, in some circumstances at least, these arrangements provide opportunities for firms and individuals to gain a better insight into the operations of the public sector. The result is intended to be a better performing public service. The primary emphasis is on complementary effort for greater effectiveness, basically using the economist’s notion of comparative advantage.

Maintaining Our Professional Credibility

It is imperative the ANAO is credible to our major stakeholder, the Federal Parliament. As with other public sector entities, we are judged on our performance. We recognise that perception is an important part of such judgement. It is essential the ANAO is perceived to be professional in all that it does, including the way in which it conducts its business. This is necessary to ensure the confidence of all stakeholders and the best defence of the Office if such is required. Our Continuous Improvement groups are an important catalyst in achieving this outcome. These groups constitute a cross-section of staff whose task is to identify better or best practices, and the ways we can best apply them to our work, to ensure that we maintain the Office at the highest possible level of professionalism.

A major challenge faced by any accounting or auditing institution is to keep pace with, and preferably be ahead of, developments in our profession. This includes maintenance of professional standards, fostering staff who will provide to the entities we audit (and ultimately to the Parliament) the services they need as well as maintaining facilities to help staff work to those standards and provide audit services at a high level of quality. Quality assurance is an essential element of a professional culture. For a public sector auditor it is also necessary to maintain public sector knowledge and experience at a high level. For example, our graduate administrative assistants are required to complete the Certificate III in Public Administration as part of the Australian standards framework.

The ANAO has had a long association with the professional bodies such as the Australian Society of CPAs, the Institute of Chartered Accountants and the Institute of Internal Auditors. ANAO personnel have been Office holders as well as members of various committees of those organisations. One National Business Director was Chair of the Public Sector Accounting

Standards Board and the other is being considered for membership. The ANAO chaired the Auditing Standards Committee of the International Organisation of Supreme Audit Institutions (INTOSAI) for almost a decade until last year and still retains its membership. Such involvement reflects the level of the Office's commitment to high professional standards in audit and accounting and the need to have the capability necessary to ensure our professional obligations can be met in all our audits. This is a major imperative and a real test of our professional credibility.

A lack of adequate facilities makes it very difficult to achieve the level of professionalism required. Over the past two years, we have taken significant steps to upgrade our resources capability, particularly our computing facilities and the ways we use those facilities. Being a relatively small organisation, compatibility with all our stakeholders has been a difficult goal to achieve. However, initiatives being taken on a whole of government basis may help us resolve some of the problems we face, as well as obtaining more cost effective outcomes.

Certainly, it was never a matter of merely providing staff with state of the art equipment whose facilities they would not use. The choice of those physical facilities was made at the same time as our decision to link with a major accounting firm to obtain, for example, sophisticated audit support software that no relatively small entity would have the capacity to be able to develop for itself. The physical facilities selected, including portable computers for audit staff, were those most suited to the audit tools we wished to use to achieve our objectives in relation to standards requirements as well as service quality levels determined. Those objectives must always be foremost in our minds when we are assessing our resource capabilities.

The suite of audit tools we selected, from those available from the major firms, was based on a judgement of their suitability to our own circumstances, including the skills base of our staff and the most common computing platforms in the entities we audit. We are aware that other public sector organisations in other audit circumstances, no doubt for equally good reasons, have chosen differently.

Having conducted a pilot study using this software on a number of audits over the last audit cycle, we are now implementing the selected approach across all our financial audits for 1996-97. As part of the pilot for 1995-96, our Melbourne office volunteered to adopt the computer based audit support approach for all of its audits, to test particularly the effect of such a move on the whole organisation. This has been a very successful initiative resulting in timely systems and other changes which will greatly facilitate the Office-wide introduction to a more robust and credible operational mode essential to promote staff confidence and acceptance.

While those software and hardware facilities are not inexpensive, the alternative to the approach we chose would be to have less efficient and less cost effective audits and associated services. In particular, the available audit support facilities will help us to provide a better quality service to entities and to the Parliament. As well, they have provided the opportunity to increase our audit product range and improve our client service.

Our professional credibility is tested not only through the capability of our resources to deliver high quality audit products but also to manage those resources in an efficient and effective manner. Various public service reforms have focussed our attention on the full cost of delivering our services. The ANAO's charging regime, even where no charges are actually made, reflects that approach. We have had numerous discussions with accounting firms on appropriate charging mechanisms and systems. While recognising those firms' concentration on price to get the business, their subsequent profit also depends importantly on their costs. The latter is an area where we can usefully benchmark in order to identify those processes where our costs are significantly different and require us to provide justification or alternative ways of lowering such costs. This focus on processes is likely to provide us with more useful management information than simple overall costs of audits which can be markedly different not only across entities but also between the public and private sectors.

As is increasingly becoming the case in all jurisdictions, all Commonwealth entities now report annually on an accrual basis. However, few entities in general government, that is departments and budget funded statutory authorities, consistently employ accrual information as an aid to management. The ability to do this in most cases required accrual accounting systems with links into other systems such as Human Resource Management and Planning, Decision Support and Executive Information. More importantly, it requires both a recognition of the benefits (and limitations) of accrual information and the will and capacity to manage an entity by using such information.

Clearly, we need to ensure our own house is in order. We were one of the first Commonwealth entities, with the Department of Finance, to report on an accrual basis. We are now moving to producing monthly internal accounts on an accrual basis to be used for management purposes. Putting such a system in place will clearly facilitate the production of annual accrual financial statements. However, the major reason for our move to introduce accrual accounting, as opposed to accrual reporting, was to improve the quality, timeliness and relevance of information available to managers at all levels to assist their decision-making.

While it is not achievable overnight, our aim is to be able to monitor actively the resources we use in our business and the returns we get from our activity. Together with other operational information, this should provide the opportunity to improve the allocation of our resources, both physical and intellectual, for effective auditing and service delivery. Thus, hopefully, our active use of an accrual accounting system, including for budgeting purposes, will not only help us to produce better reports but also assist in reporting better results.

II. DEVELOPING A MORE CLIENT SERVICE ORIENTATION

One area in which we can learn from the private sector is in being aware of the prime necessity of providing a quality service to clients (or our various stakeholders). This focus is a practical necessity in the private sector. Previously, it has not necessarily been recognised as being quite so important in the public sector. There are no doubt still many areas in the public sector where such a notion is considered inappropriate and may indeed be. Some argue that is because the service recipients do not really have the same types of choice. However, listening to and focussing on the needs of those recipients involve similar disciplines and approaches as if they were private sector clients. It is more an attitude of mind than simply a vehicle for marketing products.

It must be agreed, however, that for many public sector entities a culture of client service has not yet been nurtured. This culture is something that we in the ANAO are working on steadily. (This does not mean providing automatically unqualified audit reports on financial statements, or uncritical congratulatory performance audit reports.) There is no doubt that the Office has been concerned to work closely and supportively with entity staff and managers. While few of us really like criticism, there is general acceptance that constructively critical reports can help us do our job better and that recognition of good performance can both reinforce and lift the confidence and morale of those involved. As part of this more client focussed approach, we have introduced a range of different “products” we consider will be of service to entities and to the Parliament, so that they will eventually be requested by those bodies as a matter of course.

We have come to the view the ANAO must supply a broad range of audit and audit-related products to be considered really useful to the various entities and other stakeholders it is involved with. Some of the products I am talking about here are:

- financial statement audits;

- performance audits;

_ financial control and administration audits;

_ assurance and control assessment audits;

_ direct assistance to the Parliament and its Committees;

_ seminars on topics relevant to public sector entities; and

_ better practice guides and other guidance material on various topics, such as:

  - model financial statements (AMODEL Accounts) for different types of entities;
  - financial statement preparation;
  - the control environment, particularly as it impacts on financial reporting;
  - financial management; and
  - managing APS staff reductions.

The really interesting point about the development of such a wide range of audit products is that it largely results from us making maximum use of the experience and information gained from our financial statement and performance audits. I regard this as an obligation as well as an opportunity. Put simply, the additional resource commitment can be quite marginal for a quite significant outcome. As well, I pay tribute to our Continuous Improvement groups, referred to earlier, for the role they have played in this respect.

A client service mentality also sees the ANAO being more directly involved in audit related developments in entities and in the public sector generally. For example, we are working closely with both the Department of Social Security and the Department of Employment, Education, Training and Youth Affairs in the establishment of the proposed new entity to undertake the processing and service delivery tasks of those two departments. We have also been closely involved in the development of the recently released Risk Management Guidelines[1] prepared under the auspices of the Commonwealth's Management Advisory Board in association with its Management Improvement Advisory Committee (MAB/MIAC).

The logic of such involvement is compelling. It is akin to prevention rather than cure. Our role is primarily advisory and given we need to be careful to preserve our independence we stress and ensure we are not a party to any decisions. While this smacks of 'all care and no responsibility', there is general agreement that there are likely to be real benefits for all involved not only because there is a better basis for any decisions but also because there is a better understanding of the various issues, concerns and pressures which are likely to impact on those decisions now and in the future.

I thought it might be useful to illustrate our approach by discussing two of the products mentioned above. In late 1995, the ANAO implemented a program of audits known as financial control and administration audits or, more simply FCA audits, which have attracted considerable interest. We are currently developing a related program of audits which we describe as assurance and control assessment audits or ACA audits.

Audits of Financial Control and Administration

FCA audits are concerned with improving the quality of the public sector administration by assisting and encouraging agencies to achieve better practices, in areas such as asset management, accounts processing, audit committees, the use of accrual information and debt management.

These audits are intended to assist public sector managers in meeting their responsibilities and to inform the Parliament about aspects of public administration which are not likely to be covered by the financial statement and performance audit products basically because they are not likely to be significant or 'material', or have too narrow a focus, in a single entity context. On the other hand, they can have service-wide ramifications which are of considerable interest.

FCA audits are consistent with the ANAO's Vision to be valued by the Parliament, the Community and Commonwealth entities as a major contributor to achieving excellence in public sector administration and accountability. The evidence to date suggests they will also greatly assist in achieving that vision.

In this context, I wrote to heads of departments and agencies advising them of my intention to conduct these audits and received positive support for the initiative. I am pleased to say that subsequently, in a follow-up survey, the feedback was most encouraging. I have also had discussions with members of the Joint Committee of Public Accounts and the House of Representatives Committee on Financial Institutions and Public Administration where I have had a similar response.

A Catalyst for Introduction

FCA audits were introduced as a result of a review by the ANAO of the scope and targeting of its audit activities. This review was done in the context of the changing public sector environment, particularly with the increasing devolution of authority, adoption of strategies for the management of risk, changes in financial reporting and enhanced accountability.

However, the decision to undertake these audits was also based on an apparent Parliamentary perception that devolution of management authority under the Public Sector Reforms had not been matched by commensurate evidence of accountability by public service managers. The FCA audit was designed to go some way in filling this ‘expectation gap’.

Objectives of FCA audits

Specifically, the objectives of FCA audits are to:

_ provide independent assurance to the Parliament, the Executive Boards, auditee management and to the public on aspects of public administration and control of public funds; and

_ identify, develop and report better practice.

Consistent with the objective of providing assurance, these audits adopt an empathetic approach to improving public administration rather than simply identifying shortcomings or minor matters dealing with administrative processes. The latter is certainly not consistent with the risk management approach being urged by MAB/MIAC[2]. The concern is more about whether appropriate platforms and mechanisms for control have been properly implemented. In fact this reflects the growing concern for assurance about adequate internal control - a phenomenon not confined to the public sector as witnessed in the well documented, ‘AWA Case’[3].

Activities Covered

As I noted earlier, the types of activities this program addresses, while individually not ‘material’ in many agencies, collectively represent a significant element of public sector administration and account for a significant level of expenditure each year. Resource implications also often go further than just cost. Apart from issues of regularity and value for money, the audits consider issues of probity and propriety of officials' behaviour that may arise.

Essentially, these audits focus on those core, or good housekeeping, activities that are considered vital for good management. These include guidelines, instructions, monitoring practices, systems development, integrity and ethical checklists and audit trails. Again, this is not just the preserve of the public sector as the recent focus on Corporate Governance in the private sector indicates.

The Audit Output

These audits are usually undertaken across a selection of agencies, between 12 and 15 entities. The results form the basis for a view of the Commonwealth Public Service. In keeping with this holistic approach, all reporting is generic in nature. However, we do promote individual entity examples of 'better practice'. The approach encourages entities, which might not be at the better practice end of the spectrum, to be involved so that a better appreciation can be gained of what might be involved in moving to that end and the associated benefits and costs. These aspects would be examined in subsequent audits of the individual entities.

While the results of these audits are reported in the normal way to Ministers, departments and agencies, reports to the Parliament are generic in nature in order to provide Members with a good perspective of areas of best or better practice, as well as areas where improvement is warranted. Reports mention by name only those organisations which have demonstrated approaches and practices that might be able to be applied elsewhere.

The tangible outputs at the end of a FCA audit are the publication of a report to the Parliament and a better practice guide. The approach provides a benchmark against which government agencies, service-wide, are able to compare their respective performances and to implement improvements, where considered necessary. Such an indicative benchmark is also useful in later audits to ascertain what, if any, action should have been taken in individual entities. Less than adequate performance could be reported in such audits in the normal way. Such follow-up also alleviates the Parliamentary concern expressed about the generic nature of the FCA audits.

The ANAO is of the opinion that these outputs and the likely outcomes emanating from them are, and will continue to be, useful to the public sector as well as to the general public, including taxpayers. At this time we do not expect to undertake any more than 4 to 5 such audits in any year.

Only one report has been completed to date which I am about to discuss. The second is close to completion dealing with Payment of Accounts or accounts processing. A third is well underway covering Audit Committees.

Management of Assets

Management of assets was selected for the first Financial Control and Administration audit and was published in June 1996[4]. A Better Practice Guide and companion Handbook which, respectively, discuss the principles of asset management in depth and provide practical examples and case studies were also produced to assist managers both in creating more awareness of the importance of good asset management for better results and in knowing how to do it. There is certainly no advantage in trying to reinvent the wheel in this respect.

We found that asset management emerged as a major concern in most agencies and for the Parliament. The depreciated value of fixed assets held by all Commonwealth agencies is around $66 billion. About $16 billion of this amount relates to assets held by general government agencies. Their replacement cost could well be more than $30 billion.

The foregoing values imply spending approximately $3 billion a year on asset replacement for general government alone, without taking into account the cost of operating and maintaining those assets. It is fairly self-evident that, with shrinking budgets, program managers have to start looking at ways to use assets more effectively, and even to see if they can do without, or moderate the demand for, particularly expensive and underperforming assets. Clearly, they should not be reviewed in isolation from other resources, particularly when there can be substitution or alternative means of provision such as outsourcing or leasing.

For this reason, the first FCA audit focused on asset management and, not surprisingly, found that there was considerable room for improvement. Agencies have finally got their accounting books and records in reasonable order but they now need to take a more strategic approach to managing their assets. The issues go well beyond physical security and proper maintenance, as important as they are. The missing link, so to speak, is an assessment of their impact on program outputs and outcomes. In the past, the tendency was to take assets for granted and consider them to be costless in day to day decision making.

We would encourage those officials and managers responsible for asset management within their agencies to take advantage of the information and suggested practices in the publications. The move from cash to accrual accounting should ensure that decision-makers at least focus on the cost of their assets. A capital change would certainly help to concentrate the mind. But there also needs to be some incentives for managers to engage in good asset management practices. This is a policy issue.

The major recommendations from the Report are that agencies should:

- compare and assess their asset management practices against the principles contained in the report;

- review arrangements for establishing accountability for the use of assets at a program level;

- review asset policy and procedure manuals to ensure that they address all aspects of the asset life-cycle; and

- have regard to the non-financial asset management information required to effectively monitor and control assets from a life-style perspective.

Finally, we have conducted seminars and workshops relating to, but not solely confined to, Asset Management to ensure that there is general understanding of the nature and intent of the audits as well as specifically to obtain agencies' ideas and feedback on the better practices indicated and on the recommendations. While it is by no means the last word on the subject, it has proved to be a useful building block for the future.

I have discussed the report on Asset Management as an illustrative example of an FCA audit. More detailed explanations of the approach taken and the outcomes that we wish to achieve when undertaking an FCA audit are available in a published document - *Financial Control and Administration Audit - Charter*.[5]

Assurance and Control Assessment Audits

As noted earlier, we are now developing a related program of audits described as <u>assurance and control assessment</u> audits or, simply, ACA audits. They are aimed at providing to the Parliament, and to the entities involved, an assessment of the <u>level of control</u> applied to a range of very basic activities in public sector entities, such as travel and accommodation. Parliamentarians have regularly expressed concern on such "housekeeping" matters as noted in relation to FCA audits. But, in most instances, reporting on them does not sit well with reporting on the overall financial report of an entity, nor would most of the activities have a material effect (as conceived of by accountants and auditors generally) on the financial report.

The ACA audits are a direct reaction to the above concerns, since work of this type has increasingly been excluded from the scope of our basic financial statement audit. They are basically about providing assurance of key controls in individual entities rather than about identifying better practice across entities as do the FCA audits. I have advised the Joint Committee of Parliamentary Accounts (JCPA) about these audits not only because of their interest in the 'expectation gap' but also because I am treating the Committee as our Audit Committee pending the passage of the proposed Auditor-General Act.

The ACA audits will examine basic administrative processes to provide a positive assurance that agencies are meeting their obligations under the legislative framework. They will be concerned only with the financial framework established to support and assist in the delivery of the products and services provided by the public sector. These audits will not assess compliance with legislative provisions governing specific programs. However they will be focussed on the common or core activities of a corporate nature, for example personnel practices, travel and accommodation, minor expenditure, procurement and use of official vehicles. From time to time the coverage of FCA audits is likely to be highly complementary to ACA audits.

Reporting on these audits will be in association with my annual report to the Parliament on financial audits. The reporting style will be similar to that of FCA reports in that it will be at a generic level to provide a service-wide perspective. However, our management letters will advise entities of any specific matters which may need to be addressed. The concerns are most likely to be about whether the control environment is effective or not, rather than about any relative position against other entities, as is more likely to be the case with FCA audits.

III. CORPORATE GOVERNANCE

Background

Simply put, corporate governance is about how an organisation is managed, its corporate and other structures, its culture, its policies and the ways in which it deals with its various stakeholders.[6] Corporate governance has been an issue in the private sector since the advent of joint stock companies in the United Kingdom (UK) in the eighteenth century. The core of the issue is, and has long been, how to ensure that the interests and expectations of owners and other stakeholders of corporate bodies are adequately addressed by the governing body and the executive management of corporate bodies.

Corporate governance (as an all embracing framework) has become a major issue in the last decade. The "excesses of the 1980s" resulted in a series of financial disasters leading to questions, amongst other things, about management and director responsibilities including, importantly, to shareholders.

In 1985, the American Institute of Certified Public Accountants (AICPA) and other professional bodies co-sponsored the creation of the Treadway Commission (The National Commission on Fraudulent Financial Reporting) to identify the causes of fraudulent financial reporting. The Commission reported in 1987.[7] One of the consequences of this report was the establishment of the COSO (Committee of Sponsoring Organisations of the Treadway Commission) task force to integrate internal control concepts and definitions. The COSO Report *"Internal Control - Integrated Framework"* was published in 1992[8]. In the same year, the well known Cadbury Committee Report[9] (The Committee on the Financial Aspects of Corporate Governance chaired by Sir Adrian Cadbury) was published in the United Kingdom.

The Australian Institute of Company Directors and other professional bodies have been mirroring these developments and setting them into the Australian context. The most recent development was the introduction of the corporate governance listing rule (4.10.3) by the Australian Stock Exchange (ASX)[10] which requires listed companies to make statements on corporate governance issues in their annual report on or after 30 June 1996 (see Appendix 4A of the ASX Listing Rules).

There have also been a number of spectacular financial collapses in various <u>public</u> sectors in Australia. In addition, there have been several instances of public sector agencies failing to meet the non-financial expectations of both regulators and stakeholders on a fairly extensive scale.

Defining Corporate Governance

There are many statements that attempt to define corporate governance. The following two quotations encapsulate the main principles which are consistent with my earlier simple explanation.

In his decision of *AWA v Daniels*[11], Rogers C.J. outlined the functions of the board being to:

_ set the goals for the corporation;

_ appoint the corporation's chief executive;

_ oversee the plans of managers for the acquisition and organisation of financial and human resources to attainment of the corporation's goals; and

_ review at reasonable intervals the corporation's progress towards attaining its goals.

The International Task Force on Corporate Governance of the International Markets Group last year commented as follows:

> "Corporate governance focuses on the processes used to direct and manage the business and affairs of the company with the objective of balancing:
>
> _ the attainment of corporate objectives;
>
> _ the alignment of corporate behaviour with the expectations of society; and
>
> _ the accountability to recognised stakeholders."[12]

As can be seen from these different sources, the theme is reasonably constant. Corporate governance is predominantly about the control and monitoring mechanisms that are put in place by organisations with the object of enhancing stakeholders' value and confidence in the performance and integrity of the organisation. These sentiments have also been strongly supported by the two major accounting bodies.[13]

Corporate Governance in the Public Sector

I have indicated how corporate governance has become a well documented and prominent topic in the private sector. The issue for us is what is its possible application in the public sector. The concerns are broadly the same. That is most apparent in relation to the government business enterprises (GBEs). But why should we stop there? While the accountability requirements in the general public sector can be quite complex, the principles are similar. As well, those accountability requirements are changing with a more commercially (or even private sector) oriented public service.

A fundamental difference between corporate governance of companies and governance of an entity is that the Chief Executive Officer (CEO) of a public sector entity is directly responsible for its performance. There will be a clear legal liability in the proposed new Commonwealth financial management legislation which is expected to be in place by 1 July 1997. CEOs are responsible to their Minister for advice they provide and, as the leaders of their entities, assume full responsibility for the work of their subordinates. In a number of areas the responsibility is legally directed. Of course there are legal requirements on private sector Directors and CEOs but not to the same direct extent.

Fundamental changes have been and are still being enacted to change and reform the Australian Public Service (APS). As a result the APS will be focussed more on customer service and will operate in a field of new demarcations between purchasers and providers of services and between policy and program delivery. The Ombudsman has referred to a 'no-man's land' of accountability and unpublicised transfer of risks.[14] The integrated elements of a corporate governance framework should alleviate such concerns.

While it may not have been referred to as corporate governance, the governance principles in the public sector have been evolving over recent years. However, with the exception of the proposed financial management legislation, the following APS governance elements do not have the legislative backing that applies to private sector governance principles under the Corporations law and ASX listing rules:

- Financial Management Improvement Program (FMIP);
- MAB/MIAC accountability guidelines;
- APS Values and Ethics;
- MAB/MIAC Risk Management Guidelines; and
- the proposed Financial Management and Accountability, and Commonwealth Authorities and Companies Acts.

Under these reforms management will have greater flexibility, a less hierarchical structure and greater devolution of authority. The APS will be subject to increased levels of scrutiny of its performance and effectiveness. At every level, entities will need to establish a culture of ongoing evaluation and assessment against models of best or better practice.

The Nature and Possible Relationship of Corporate Governance to the Public Sector

Corporate governance is fundamentally about how we manage ourselves. It is about providing assurances to stakeholders that we are keeping faith with the vision, role and values set out in the organisation's Corporate Plan, as well as in any Code of Conduct.

Corporate governance is about ensuring that the organisation and its people exhibit high standards of official conduct and professional practice in accordance with recognised professional and APS standards and ethics.[15]

The values, standards and practices which underpin corporate governance in public sector agencies flow from peak APS values, obligations and standards, which in turn are derived from legislation, policy and accepted conventions.

Elements of good corporate governance will:

- demonstrate that managerial disciplines are in place;
- assist with planning and decision making for management;
- complement any review and evaluation of program management;
- identify best public sector practices;
- establish credibility with external parties; and
- provide a defence against internal/external criticism.

Key Considerations in Applying Corporate Governance to the Public Sector

In the private sector there is a clearly defined relationship structure between the main parties. The generic private sector governing structure consists of a board of directors including the chairperson of the board and a Chief Executive Officer (CEO) responsible for the ongoing management of the agency.

However, this model is not readily transferable to the public sector because of the different relationship between the CEO and the Minister as noted earlier. However, many public sector agencies are developing a Board of Management to assist the CEO in the running of the agency, at least at the strategic policy level. A major variation of the private sector approach is that most of these Boards comprise senior managers from the particular agencies and thus do not provide the apparent independence of the private sector Board. Very occasionally, such public sector Boards do have one or more independent members.

Implications of the agencies' governance responsibilities for the relationship between the CEO and Ministers will need to be closely examined. There may be an opportunity to formalise relationships with Ministers, perhaps through the development of a written agreement or memorandum of understanding as is done, say, in New Zealand. Formation of a private sector governing board is driven by legislation. By comparison, public sector boards usually have an agreed Charter but no legal rules to guide or bind them other than any particular legislative requirement under the Public Service or current Audit Acts or any legislative requirements relating to particular programs.

Existing boards, executive committees and other committee structures within the entity could be integrated to become part of an overall framework for exercising corporate governance principles. In most cases this would entail reconstitution and redesign to ensure that the core focus is one of those governance requirements and the discipline that goes with them.

A sound governance framework would assist an entity to, amongst other things:

_ achieve corporate objectives;

_ identify and manage risk;

_ promote high ethical standards;

_ ensure roles and accountabilities are clear;

_ provide relevant and timely information to the appropriate people; and

_ meet emerging benchmarks for internal control.

Before examining how we might construct such a useful corporate governance framework in the public sector, it might help to be clear about some of the basic principles involved.

Some Basic Principles of Corporate Governance

Corporate governance is not only about managing for results but also demonstrating to the stakeholders its benefits through an increase in the value of the organisation and enhanced confidence by the stakeholders in the organisation's credibility, viability and future prospects. The parallels between the public and private sector in these respects are readily apparent.

Corporate governance involves an integrated system of controls, financial and otherwise, established in order to provide reasonable assurance of:

_ cost effective and efficient operations;

_ internal and external financial integrity and validity; and

_ compliance with laws and regulations.

In discussing effective and efficient operations, management disciplines including risk management have to be addressed. Risk management requires the identification of all risks, determining their priorities and an evaluation of such risks for their potential impacts on the entity. On the basis of this evaluation, decisions are taken to apply the entities' limited resources in accordance with the judgements made. Further evaluation and reporting of results follows at a later date to ensure that appropriate decisions were made and, where applicable, revised decisions are made and timely action taken, including effective 'damage control'. Management disciplines involve having the appropriate:

_ organisation culture;

_ organisation structure;

_ planning framework;

_ management information systems; and

_ human resource management and planning (HRM) systems.

Internal financial controls provide reasonable assurance that the assets are safeguarded against unauthorised use or disposal with the maintenance of reliable accounting records. Such controls should also ensure that financial information used within the agency provides a credible base for external publication.

Corporate governance is only one aspect of the continuum of legal and ethical accountability which can be illustrated for the public sector as follows:

Public Governance

(policy setting)

Public Sector Governance

(public service standards, obligations and values)

Organisational Governance

(organisational ethos, values, standards and expectations)

Business Unit Performance

(adherence to corporate values, mission and goals)

Individual Conduct

(behaviour and attitudes consistent with corporate values, mission and goals)

Building A Governance Framework Within Public Sector Entities

While public sector agencies vary in their organisational complexity, size and client base, they currently have largely common internal structures which support the CEO's decision making. These same structures would be essential building blocks to form a governance framework for the entity. The support structures involved are those relating to:

- values and ethics;
- internal accountability;
- external accountability;
- financial management; and
- resources, including asset, management.

I will now discuss each of these in more detail.

Values and Ethics

A clear set of values supported by a code of ethical conduct provide a basis for assurance to the CEO that there is consistent ethical behaviour at all levels of the agency and that its employees:

- comply with general public sector standards, codes of ethics and other applicable codes of conduct (eg. for those of professional bodies);
- act with integrity in the performance of official duties and are beyond reproach in the use of official information (usually required under the above codes);
- exercise consideration, sensitivity and openness in their dealings with members of the public and fellow employees; and
- identify and deal decisively with any real or perceived conflict of interest.

Internal Accountability

Clearly enunciated control mechanisms, guidelines and review/monitoring procedures enhance the confidence a CEO can have in internal control and management of the organisation and the planning and review of its operations and progress, while fostering consultation and feedback on all its activities.

Accountability structures for internal management of the entity include executive committees, audit and other operational committees set up for specific tasks.

Structures for entity planning and review include the corporate, strategy, business, risk management and HRM plans, internal delegations, quality control systems, benchmarking, evaluation and performance monitoring to ensure that all responsibilities under the control of the CEO are carried out with due care and diligence.

External Accountability

CEOs are accountable to their Ministers; who in turn are accountable to the Parliament and, through the Parliament, to the general public[16]. CEOs also have responsibility to their direct clients and other stakeholders which need to be clearly identified.

An entity which has a clear understanding of its responsibilities and an open (transparent) approach to the way in which they are discharged will greatly assist the CEO, Minister and the government in framing and winning support for identified strategies. It will also increase general confidence in the operation of the public sector.

Financial Management

A clearly defined financial management framework provides a sound basis for assurance to the CEO that the entity's resources are being managed efficiently, effectively and ethically. Such a framework should include:

- preparation of financial statements;
- implementation of a fraud control plan;

- establishment of an effective Audit Committee;

- support for a credible internal audit and evaluation capability; and

- ensuring the accounts and records are maintained as required.

Resources, including Asset Management

A well articulated resource management planning and operational structure can provide assurance to the CEO that human resources, facilities, equipment and records are being managed effectively, efficiently and ethically.

However, good governance requires more than having committees, guidelines and reporting mechanisms. It also requires control structures which are designed to deliver corporate objectives. All existing internal entity resource management structures would need to be reviewed and probably refined or reconstructed to support a cohesive corporate governance framework. Again, the concern is to ensure a well integrated and mutually supportive set of structures.

Indicative Recent Corporate Governance Developments

In terms of allowing us to “Profit From Our Experience” in the area of corporate governance, there is much the public sector can learn from the experience of our private sector colleagues. As I said earlier, however, it is important that the particular conditions and circumstances arising in the public sector are sensibly taken into account by private sector advisers and by public sector managers. We have already learnt that, while private sector solutions may not be directly translatable to the public sector, there are suitable alternatives which can help achieve a similar outcome.

As a result of the recent recognition of the need for good corporate governance in the public sector, the ANAO along with other public sector agencies has been involved in developing suitable public sector governance frameworks that are credible, are of real benefit to management and enhance external scrutiny.

The ANAO has worked closely with the Australian Taxation Office (ATO) in the establishment of its Corporate Governance Framework. The ATO Audit Committee plays an important role in that framework as does the internal audit function. The ANAO has been interested to establish the extent to which better practices in the private sector can be applied in such situations as well as to identify particular approaches that might be required in the public sector.

The ATO framework:

_ incorporates risk management to prioritise work;

_ allocates funds and identifies appropriate systems;

_ sets standards and controls to deliver the work; and

_ incorporates a capability to monitor, revise and regularly report on risk and the management objectives established for the business.

ATO management recognised the importance of probity and propriety as part of public sector accountability requirements. Adherence to a value system and the discipline of a Code of Conduct are important elements of any governance framework. The ANAO has also benefited from its involvement with the ATO initiative through a better understanding of its business, culture, systems and operations which should result in more efficient and effective audits.

The ANAO is currently developing a "Public Sector Corporate Governance Statement" which is designed to assist CEOs in establishing an appropriate framework for their entities which we anticipate will lead to efficient and effective use of Commonwealth resources in a fair, equitable and ethical manner. It is a topic MAB/MIAC may wish to develop further as guidance for the whole APS.

In addition, as part of my annual report to the Parliament on the activities of the ANAO for the 1995-96 financial year, I have included a section on corporate governance activities within the ANAO along the lines of the requirements of the ASX listing rules.

IV. WHOLE OF GOVERNMENT FINANCIAL REPORTING

One of the major challenges currently facing public sector accountants and auditors is the adoption of whole of government[17] accrual-based financial reporting requirements. While there is overwhelming agreement that the growing demands for greater transparency and better performances present real challenges to governments, there is still not general agreement about the benefits of such reporting. In this part, I will attempt to put recent decisions on whole of government reporting into some perspective, outline some of the conceptual and practical problems we are facing in implementing such reporting and argue that the information provided by this reporting creates opportunities for improvements in public sector management and accountability and overall better performance. I have earlier touched on the difficulties being faced in managing and budgeting on an accrual basis but leave that discussion to another day.

Putting Recent Decisions on Financial Reporting by Governments Into Some Perspective

As explained earlier, whole of government financial reporting involves preparation of general purpose financial reports consolidating the financial results of all departments, authorities and companies controlled by a government. In order to appreciate the challenges facing governments in adopting whole of government reporting, it is necessary to understand the history of financial reporting within governments. Historically, financial reporting within the Commonwealth budget sector consisted of statements prepared by the Minister for Finance reporting on cash transactions against the central budget. While this was supplemented with accrual reports prepared by government companies and authorities, government departments did not, until recently, report on their own financial activities.

In the late 1980s, government departments were first required to prepare cash-based financial statements and to incorporate these into annual reports which were tabled in the Parliament. In the early 1990s, accrual reporting was first introduced in Commonwealth government departments and by 1994-95, all departments had fully implemented accrual reporting even though this was only achieved by processing end of year accrual adjustments.

The recent evolution of accrual reporting means that the current generation of senior management within the public sector echelons has grown up on a diet of cash based management and accountability. It would be fair to suggest - as indeed surveys show - that the majority of these officers have only limited experience or knowledge about the use of accrual information for management purposes. Most Commonwealth government departments currently report externally on an accrual basis, but manage internally on a cash basis. At the whole of government level, both reporting and budgeting is cash based. In such an environment, there was always going to be some resistance to the concept of accrual reporting and accounting within the government sector.

While it has received considerable attention in recent times, whole of government reporting is not a new issue. The New Zealand and New South Wales governments have been preparing whole of government reports for a number of years now. In 1993, my predecessor raised the issue of whole of government reporting within the Commonwealth when he argued that there were deficiencies in the then existing financial accountability mechanisms and recommended the adoption of whole of government financial reporting by the end of the 1994-95 financial year[18].

This theme was picked up in two inquiries conducted by the Commonwealth Joint Committee of Public Accounts in 1995. In the first, *Accrual Accounting - A Cultural Change,*[19] the Committee examined the use of accrual reporting and accounting within the Commonwealth and made a number of recommendations aimed at increasing the use of such information.

These recommendations reflected the Committee's concern that many of the benefits in accrual accounting and reporting were not being realised, which in turn prevented full achievement of the ongoing broader public sector reform process. The Committee felt that greater acceptance of accrual information was required in order for public sector managers to demonstrate full accountability, to measure fully the cost of operations and to demonstrate proper consideration of the longer term obligations and overall financial position resulting from management decisions.

The Committee then turned its attention to accrual reporting on a whole of government basis. The Committee considered that:

> *Whole of government reports would contain information of value to Cabinet, to the government's key economic and financial advisers, to Parliamentarians and to many other external users. They would help inform strategic decisions about government priorities and policies, and would enable the government to better account for its use of public resources.*[20]

In the light of this, the Committee recommended that:

> *The government should commit itself to the preparation, at least annually, of whole of government reports for the Commonwealth.*[21]

Later the same year, the Committee conducted a further investigation into whole of government reporting, considering factors such as the form of these reports and the timing for implementation of such reporting[22]. The Committee continued to support strongly the preparation of such reports but acknowledged that, unless there was a mechanism for feeding the information into financial planning and budgeting, the full benefits of this reporting would not be realised. The Committee went on to propose a financial reporting framework which linked accrual based budgeting and reporting.

The Committee recommended that the Commonwealth Department of Finance and the ANAO embark upon a series of three trial whole of government financial statements commencing with the 1994-95 financial year, with a view to full adoption of whole of government reporting in 1997-98[23]. This would be supplemented, in due course, with accrual based Commonwealth budgets.

Around the same time as the Committee was investigating whole of government reporting, the accounting profession released its first exposure draft (ED62 - Financial Reporting by Governments) on the topic. The position adopted in the exposure draft was consistent with that of the Committee, requiring full consolidation of the accounts of all entities controlled by governments. The Exposure Draft will shortly be promulgated as an Accounting Standard, which is likely to require full implementation of whole of government reporting by 30 June 1999. The Federal Government will meet that timetable.

The Committee, together with the various Australian governments through the Heads of Treasury group and a joint Heads of Treasury Accounting and Reporting Advisory Committee, provided input into the development of the Standard.

The ANAO was also able to participate in development of the Standard. In addition to commenting directly on the Exposure Draft, the ANAO participated via the provision of advisers and the secondment of a senior officer to the second Parliamentary Committee investigation. ANAO officers also attended meetings of the Heads of Treasury advisory committee in an observer role and worked with the Australasian Council of Auditors-General in providing an auditor’s perspective on the standard.

Developing a Trial Set of Financial Statements

The ANAO is a firm supporter of whole of government reporting. However, we recognise that its implementation needs to be managed carefully. We see little benefit in adopting such reporting if the Commonwealth is unable to cope with the associated reporting requirements. With this in mind, we have attempted to ensure that the timing of the introduction of the reporting takes account of our knowledge of the current reporting capabilities within the Commonwealth.

In line with recommendations of the JCPA, the Department of Finance and my Office prepared a trial set of financial statements based on 1994-95 financial information of Commonwealth entities. The emphasis of the trial was on determining an appropriate form for the financial statements and identifying the best means to obtain the information required for the financial statements from the 200 or so entities to be covered within the Commonwealth. My objective in participating in this, and in later trials, is to ensure that all issues which could result in an eventual qualification of the financial statements are resolved at the trial stage before audited statements are required to be produced.

The trial statements were published, together with an invitation to comment, by 30 September 1996[24]. With slight amendment, they were also incorporated into the report prepared by the National Commission of Audit[25]. The National Commission of Audit strongly supported whole of government reporting, recommending that fully audited statements be available for the 1996-97 financial year. The Commission reiterated the point that accrual reporting needed to be integrated with a comprehensive accrual financial management framework. A key recommendation of the Commission was that:

> *The government should formally adopt accrual principles as the basis for an integrated budgeting, resource management and financial reporting framework both at the agency level and at the aggregate budget sector level.*[26]

The Commission's recommendations in relation to whole of government reporting have been accepted by the government with the current intention being to produce audited statements for year 1996-97. Consideration is continuing of the desirability of adopting the accrual budgeting recommendations.

I would expect that, over time, such an accrual management framework would play an integral role in the government's recently announced fiscal responsibility legislation.

My Office is currently working with the Department of Finance on the preparation of a second trial set of whole of government financial statements. This trial is an extension on the previous one in that we will be conducting, and reporting on, an audit of the trial statements. By this means, we hope to identify and resolve any issues that may threaten a qualification in the eventual statements.

Having set out the background to whole of government reporting at the Commonwealth level, in the next section of my paper, I will discuss some of the challenges that such reporting has posed, and continues to pose, for the Commonwealth.

Some Conceptual and Practical Problems

One of the main problems facing whole of government reporting is the question of the validity of the information produced by such reports. Many witnesses appeared before the Joint Committee of Public Accounts arguing that the historical cash basis of reporting was more appropriate in a government environment and that the results of accrual reporting were potentially misleading. The simple argument in the Commonwealth context is often that most of the transactions are merely cash transfers involving limited assets. The Audit Commission also took considerable effort to explain that the bottom line on the financial statements <u>should not</u> be interpreted in a way analogous to a private sector set of financial statements.

A key concern of these groups was the possible interpretation of 'net worth' and associated questions of solvency which could be placed on the bottom line. The government does not have a profit making objective and from time to time may deliberately incur deficits for wider fiscal management purposes. The net assets balance is not an indicator of the Commonwealth's solvency nor the sustainability of its financial position. This reflects the fact that the statements do not and can not take account of all of the Commonwealth's assets and liabilities, as those terms may be understood by the general public. An associated problem was seen with the consolidation of different types of public sector entities ranging from fully budget funded traditional public service departments to fully commercial and competitive government business enterprises. The Commonwealth has gone down the consolidation rather than the equity route (as in New Zealand).

For example, a significant "asset" of the Commonwealth is its power to tax. While this power is not wholly unfettered, it provides a strong assurance as to the Commonwealth's ability to meet its obligations. The accounting framework which underpins preparation of the financial statements does not contemplate the reporting of this key "asset" of the Commonwealth's. Thus, while the 1994-95 trial statements disclose a $73 billion asset deficiency, the National Commission of Audit highlighted that:

The difference between total assets and total liabilities would be misleading if viewed as equivalent to the terms 'net worth' or 'equity' as often applied to commercial entities. The value shown for net assets is not an indicator of the Commonwealth's solvency or the sustainability of its financial position.[27]

Similarly, a set of major obligations of the Commonwealth is the pensions and other welfare entitlements committed to under existing government policy and legislation. The value of such commitments is likely to exceed by far the Commonwealth's superannuation liabilities which have been the focus of much recent attention. The trial financial statements have treated these amounts as constituting an expense at the time of payment on the basis that it is only at this time that the government is committed to fulfilling the entitlement under existing policy and legislation.

These are just some examples where we are seeking to position public sector reporting into an accounting framework originally developed primarily for private sector operations. Other issues still to be fully resolved include application of the concept of control of entities within the government framework, the timing of recognition of non-reciprocal transactions, the correct method of measuring superannuation obligations, and the question of how to report currency on issue in the financial statements.

The control question is a difficult one which has resulted in differences between some Treasury departments and the respective Auditors-General. ED62 indicates control exists:

where a government has the capacity to dominate the financial and operating policies of another entity, directly or indirectly, so as to enable that other entity to operate with it in pursuing its own objectives.

The draft suggests the following factors will indicate control:

_ the entity is accountable to Parliament, the Executive or to a particular Minister; and

_ the government has the residual financial interest in the net ssets of the entity.

It also lists a number of circumstances in which an entity would be deemed to be accountable.

The New South Wales consolidated financial statements have been consistently qualified for exclusion of certain entities from the reporting entity. Some examples of control issues faced by New South Wales include:

_ universities - while universities are publicly funded and are required to conduct and report on their financial operations in line with the relevant state or Commonwealth legislation, it is unclear as to whether they are ‘controlled’ by the governments in terms of the Accounting Standards. Governments do not have the capacity to control the day-to-day operations of the universities and generally, do not have the power to appoint a majority of members of university councils; and

_ environmental trusts through which the government sets aside funds for specified environmental activities. One view is that such trusts are not controlled as the government does not have a presently exercisable power to redeploy the trusts’ assets for its own benefit but can only do so by legislative amendment. The opposing view is that, as the trusts are meeting the government’s environmental objectives and the government decides on what projects will be funded, the trusts are controlled by the government and should be consolidated into the whole of government reports[28].

In the Commonwealth sector, control appears to be less of an issue as there is general agreement about the status of the vast majority of significant Commonwealth bodies. While some control issues remain to be resolved, none of the relevant entities is of such financial significance that its inclusion or exclusion would have a material impact upon the overall financial statements. Nevertheless it is clearly desirable, in my view, to obtain broad agreement for consistency of presentation and credibility with users.

One issue which is creating concern within the Commonwealth, however, is the treatment of non-reciprocal grants and the impact that these have on the financial statements. Non-reciprocal grants are grants made by the Commonwealth for which the Commonwealth receives no direct reciprocal benefit. The main examples are payments made by the Commonwealth to the State governments for the provision of health and education services. These payments are typically made under agreements covering a period of 3 to 5 years.

Under the existing accounting framework, the Commonwealth is required to book an expense and liability in the year the agreement is entered into. The liability is reduced over the following years when the actual payments are made. At no stage is the Commonwealth able to book an asset in relation to these amounts, as there is no benefit flowing back to the Commonwealth from these payments.

The impact of this treatment is that, in the year the Commonwealth enters into the agreement, it will have a large, lumpy expense and liability. In following years, there will be no expense. It has been argued that this treatment does not reflect the economic substance of the transaction which is that continuous funding is provided each year notwithstanding the periodic renewal of multiple year funding agreements. The impact of this is significant. In the 1994-95 trial financial statements, the net operating deficit was increased by $5.6 billion (or more than doubled) as a result of the decision to report in line with the economic substance rather than the legal form of these agreements.

While my office is sympathetic to arguments about the economic substance of the transactions, the current reporting framework has been breached by this treatment. We are therefore working on means by which the accounting framework and governments' economic reporting needs can be better aligned to cater for such arrangements. This is one area in which the trial has been useful in highlighting issues for resolution. The treatment of grant agreements has been raised with the Public Sector Accounting Standards Board for further clarification and resolution[29].

Another significant issue facing the Commonwealth is in relation to the measurement of the Commonwealth's unfunded superannuation liabilities. When the Commonwealth discharges this liability, it will normally obtain savings in old age pension payments to past employees and receive some income tax on the superannuation payments. It has been argued that these "reciprocal benefits" provide an offset to the liability - in the Commonwealth's case an offset estimated at $30 billion. This matter is on the drawing board for future consideration. However, given that neither the Commonwealth's future pension obligations nor its future taxing powers are currently reflected in the financial statements, it is difficult to see the logic behind bringing to account adjustments to these amounts.

An equally difficult issue is how to account for the currency which the Commonwealth issues. Do the bank notes in our pockets represent an asset or a liability of the Commonwealth? The position adopted, and one which I might say has attracted some criticism, is to treat the currency on issue as an $18.5 billion liability of the Commonwealth. This treatments reflects the fact that, when the Reserve Bank issues currency notes to the commercial banks, it receives in exchange funds equal to the full face value of the notes issued. The treatment is consistent with that in a number of major countries. However, some do not apply this treatment.

In light of the unresolved issues and unclear accounting treatments I have discussed, there is still some way to go to determine in what ways could best use be made of such reporting. For example, any variation on accounting policies adopted (for example, a decision not to record currency on issue as a liability) would have a significant effect on the financial statements.

In my view, the final position adopted in relation to some of these issues is less important than ensuring that the position is clearly described in the financial statements and consistently applied on a year to year basis. I suspect that trend information is likely to prove most beneficial. Given this, I also see some real opportunities for improvements in Commonwealth financial management and accountability arising from the availability of accrual information for management and reporting purposes. In the final section of this part, I will outline what I see as some of the major benefits.

Opportunities for Improvements in Public Sector Management and Accountability

An accrual financial management framework, under which government and entity budgets are set, managed and reported on an accruals basis, is clearly superior to a cash-based system from both an accountability and a management perspective. This is not to downplay in any way the importance of information on cash flows as I have been reminded by Professor Russell Mathews. But we are also interested in costs and the extent of our liabilities and future commitments. All these, and other elements, have to be managed. We need to plan for, not wake up to, unpleasant surprises.

As you are aware, the fundamental distinction between cash and accrual reporting is that accrual accounting records transactions at the time the economic value is created, exchanged, transformed or extinguished rather than when the associated cash flow occurs. The objective of accrual reporting is to compare the full expenses and revenues of a period and to show the value of resources controlled and obligations outstanding at the end of that period.

As a consequence, items such as depreciation and amortisation, gains and losses from the Commonwealth's asset sales program, and the write down of assets are reported for the first time in the trial whole of government statements.

All accrual revenues and expenses reflect cash flows occurring at some time. However, the cash transaction can occur before, after or at the same time as the economic transaction. Where the exchange of economic value and cash do not occur simultaneously, the effect of the timing differences is reflected as an asset or liability in the financial statements.

Traditionally parliaments have focussed their authorisation, scrutiny processes and accountability mechanisms on cash information. This scrutiny is limited as it ignores the full regime of resources utilised by the government. As one commentator advised the JCPA in its first inquiry:

> *... if we are happy with this (limited conception of accountability) it is implicitly accepting a position where the Parliament cedes a great deal of authority over resources to the Executive. It cedes the right to take decisions which do not involve cash flows, but which may significantly affect the financial position of both the government and the taxpayers.*[30]

Accrual reporting thus provides a more comprehensive accountability framework than does a cash based system. As well, it focuses attention on inter-temporal affects of decisions by governments which may be favourable, or indeed unfavourable, in the eyes of the general public. A number of commentators have raised issues about inter-generational equity concerns. As one recently put it:

> *Generational accounting provides a practical means of judging the inter-generational redistribution implied by particular fiscal policies.*[31]

Similarly, as an accrual management framework requires the full financial implications, and not just the immediate cash implications, to be considered in reaching decisions, it makes for better decisions. This is particularly relevant in the current environment in which the Commonwealth is considering the options for outsourcing large elements of its service delivery. Such decisions can only be properly made if the true costs of in-house and external delivery are identified.

Accrual information can also assist in the management of cash by highlighting assets and liabilities that will generate or consume cash. For example, managing receivables, investments and borrowings is integral to managing cash flows.

The accrual reports provide a measure of the underlying budget deficit or surplus even where there is a balanced cash budget. This information is relevant to decisions regarding the sustainability of existing levels of government expenditure or the required levels of government revenue. It may also influence the options of the government in relation to management of assets and liabilities.

Information on Commonwealth guarantees and indemnities which qualifies for disclosure in the financial statements can assist in managing the associated risks and exposures of the Commonwealth.

Finally, although there is limited scope to compare Commonwealth whole of government financial results with the private sector or indeed, given differences in government operations, with State governments. However, within the Commonwealth arena, an analysis of trends over time should provide a useful insight into financial management and direction. The 1994-95 Commonwealth trial statements contain a number of ratios and charts which could be subject to trend analysis over a number of years. For example:

- 32% of government revenue was spent on social security and welfare compared with 9% spent on defence and 8% on education;

- government debt totalled $125 billion and the cost of servicing this debt consumed 8% of government revenue;

- government operations cost $43 billion in 1994-95 to deliver $90 billion worth of government services to the community; and

- 77% of government revenue is sourced from taxation.

There may well be items where comparisons of trends with State governments and the private sector could be useful. While there is a number of challenges facing both the preparers and auditors of whole of government financial statements, I consider that such statements, when combined with an integrated accrual budgeting and management framework, will provide opportunities for improved accountability and management with the government sector.

The concerns raised in relation to the dangers from misinterpretation of the information cannot be ignored but should be dealt with by careful disclosure and education of users. Where the correct accounting treatments are not obvious, this should be dealt with by full disclosure and consistent application of the selected accounting policies. Where appropriate, my Office will be working with the relevant bodies within the government and the profession to bring the accounting framework and government reporting requirements into line over time.

CONCLUDING REMARKS

I set out to demonstrate to you how the ANAO learns from, and applies the knowledge and experience of, its private sector counterparts and others in the private and public sectors. In this respect, as well as in others, we place a high value on our links with the accounting and auditing profession. I take this opportunity to record my appreciation for the close cooperation and assistance provided by the ASCPA, with which we have established a range of very productive working relationships.

I hope that, in discussing the challenges facing the ANAO, and our responses to those challenges, I have given some of you, at least, a better insight into the public sector and, in particular, into the ANAO as it is moving into the future. While I am concerned to ensure the professionalism and independence of the Office and its interrelationship with the Parliament, particularly through the JCPA, I am conscious of the scope we have to contribute to a better performing public service. That is why we have been leveraging off our wide audit base to extend the range of audit related services and products to Commonwealth entities.

For others, I hope I have struck an empathetic if not a sympathetic chord for the directions and initiatives being taken. This includes a degree of assurance about the level of the ANAO's commitment to adding value to public administration and our more complementary role with other stakeholders to achieve that outcome. We are conscious that action speaks louder than words. But that applies to all parties. We need to build mutual confidence and trust not as a pre-condition but as an expectation. This would indicate a mature relationship capable of dealing positively and pro-actively with the inevitable tensions and differences of views that arise in the course of audit activity.

I hope that in this respect at least we can, indeed, profit from each other's experience.

DRAFT

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10. ASX Listing Rules Chapter 4 - Periodic Disclosure Section 4.10 *'Additional informtion to be included by all entities'*, item 4.10.3; and Appendix 4A *'List of Corporate Governance Matters'*.

11. AWA Ltd v Daniels (trading as Deloitte Haskins & Sells). 7ASCR 959, 10 ACLC 933, 7 ACSR 759, 3 July 1992, NSW SC.

12. International Capital Markets Group, 1995. *'Who Holds the Reins?'* : An overview of corporate governance practice in Japan, Germany, France, United States of America, Canada and the United Kingdom : contrasting impressions of present-day practice and current issues. Prepared by the International Task Force on Corporate Governance of the International Markets Group. London : International Capital Markets Group, 1995.

13. ASCPAs and ICA 1996 *'Beyond the Gap'* Report of the Financial Reporting and Audit Expectation Gap Task Force to the Joint Standing Committee. June (pages 8 to 13).

14. Harris, Trudy 1996. *'Consumers exposed in shift to contractors : Ombudsman'*, The Australian, 19 September (page H4).

15. MAB/MIAC (May 1996). *Ethical Standards and Values in the Australian Public Service*, Report No.19, Commonwealth of Australia, AGPS, Canberra.

16. MAB/MIAC 1993 *'Accountability in the Commonwealth Public Sector'*, Report No.11, AGPS, Canberra, June (see particularly pages 3 to 7 and 13 to 16).

17. Whole of government financial reporting involves preparation of general purpose financial reports consolidating the financial results of all agencies controlled by a government. Such agencies include government companies, authorities and departments. As noted later in the text of the address the Commonwealth government prepared trial whole of government reports for the 1994-95 financial year. These reports involved consolidation of some 200 entities including largely commercial organisations such as Telstra and Australia Post, through to core government agencies such as the Australian Taxation Office and the Department of Defence. These statements were, with slight amendment, incorporated into the National Commission of Audit's report to the Commonwealth government. The Commonwealth is currently conducting a second trial with a view to preparing fully audited statements for the 1997-98 financial year.

18. ANAO Report No.34 1992-93, *'The National Bankcard, Who Will Pay the Piper?'*, AGPS, Canberra (page 34).

19. Joint Committee of Public Accounts 1995, '*Accrual Accounting - A Cultural Change'* Report No.338, 1995, August

20. ibid. (page 85-86).

21. ibid. (page 86).

22. Joint Committee of Public Accounts, 1995, *'Financial Reporting for the Commonwealth : Towards Greater Transparency and Accountability'*. Report No.341.

23. ibid. (page xvi).

24. Minister for Finance 1996 *'Trial and Unaudited Financial Statements of the Commonwealth Government of Australia for the year ended 30 June 1995',* AGPS, Canberra, 28 August.

25. National Commission of Audit, 1996, *'Report to the Commonwealth Government'*, June.

26. ibid. (page 211).

27. ibid. (page xxi).

28. Gibson, Greg 1996. *'To Consolidate or Not to Consolidate'*. Address to Senior Audit Executives Conference, Sydney, 21 June. (This address covers a range of interesting differences of views between the NSW Audit Office and the Treasury.)

29. Carter, George 1996. *'Accrual Accounting : A Vision for the Future',* Public Eye No.230, 15 August (pages 7, 8 and 18).

30. op. cit., Joint Committee of Public Accounts, Report No. 338 (page 83).

31. Ablett, John,1996. *'Budgeting to Bridge the Inter-generational Gap',* The Australian, 7 October (edited version of an article due to be published in the Spring issue of Agenda, the quarterly journal of the faculty of economics and commerce at the Australian National University).