

Submission to Qld Public Accounts Committee

“Government Financial Reporting”

Background

CPA Australia's Public Sector CoE has been conceptualising over a similar issue over the last few months. Towards the end of 2004, the CoE embarked on a project to identify the usefulness of financial and performance information in the public sector. The CoE has been interested in exploring whether the information prepared for reporting purposes in annual reports and budget papers, for example, is used for decision-making purposes or it is simply a compliance exercise, especially in the case of financial information.

The CoE recognises that this issue of the usefulness of financial information is important given that 2005 is the year of Australian Equivalents of International Financial Reporting Standards (AIFRS) and by all accounts could even be the year of the adoption of the revised AAS31 standard asserting the use of harmonised GFS/GAAP, for the preparation of whole-of-government reports. Is all of this going to add to the existing complexity of reading and digesting a public sector financial report?

We recognise that much work goes into the preparation of financial and non-financial information for inclusion into reports and would like these documents to be understandable and useful to users for making informed decisions.

State Of Play - Work Undertaken to date by the CoE

Article – Public Sector Newsletter (February 2005)

The approach taken by the CoE in developing some insight on this topic was to obtain some user perspectives validate existing views. As such, an article was published in CPA Australia's Public Sector Newsletter, requesting comments from members. More specifically, questions asked were as follows:

- What do you think are appropriate key performance indicators (KPIs) for your area?
- Do you agree that KPIs should be audited/verified?
- Should a standard set of key performance measures for the public sector or groups of similar agencies be established for comparative purposes?
- Is there a need for a performance indicator to assess the effectiveness of governments expenditure/investment in a project (ie with linkages to outputs and outcomes and reported on a time series basis where projects or initiatives extend over years)?
- Do you believe that current financial reports (financial statements and notes) prepared by governments are used for decision-making? If not, how could they be improved?
- What affect so you think AIFRS and/or GFS/GAAP will have on the usefulness of financial information?
- Any other comments on the issue of financial or performance information, generally?

Response to Article - Australasian Council of Auditor's-General (ACAG)

A response was received from the Australasian Council of Auditor's-General (ACAG)¹. Identified below are some key points from this response.

ACAG supports the development of cost effective performance measures that provide relevant information to stakeholders (including decision-makers) and/or assist agencies in achieving their strategic objectives and outcomes. This includes measures that go beyond traditional financial measures to include those aspects of the business that are strategically important (ie the linking of performance measures to strategy).

ACAG agrees that there are benefits to be derived from the publication, verification and auditing of agency KPIs. Such an audit function is undertaken in some jurisdictions (WA, ACT and Victoria – has the discretionary mandate to audit KPIs) and the benefits these jurisdictions have noted from such KPI reviews. However, there will be a need to recognise the difficulties that may be encountered in developing verifiable performance indicators in a non-market environment and in developing appropriate systems to capture the data to be reported and audited. These matters have been largely overcome in WA and the ACT.

While it may be difficult to develop a standard set of measures, it is essential that the measures reported are developed within a consistent performance management reporting framework (as occurs within accounting standards). Some Australian governments prepare budgets based on an outcome budgetary framework. In these situations, it is essential that the budgets be formed consistently with this reporting framework, thus facilitating subsequent comparative reporting. Equally essential is that the measures determined are relevant to the day to day management of an entity and that the measures be reported on a regular basis as part of internal management reporting.

The evaluation of government expenditure/investment in a project with linkages to outputs and outcomes and reported on a time series basis forms an essential part of good project management and public sector accountability.

When considering financial reporting by governments it should be acknowledged that the range of stakeholders and potential users of financial statements may extend beyond those traditionally identified in the Statement of Accounting Concepts, as those who are dependent on general purpose financial reports for information for making and evaluating resource allocation decisions. In the case of government entities, interested parties or users may include public sector employees, unions, lobby groups, potential partners and competitors as well as the general public to whom the government (through Parliament), is ultimately responsible.

Interviews with Public Accounts Committees (PACs)

Interviews were held with secretariats to PACs in most States in Australia (excluding Tasmania and NT), to obtain some insight into a parliamentarian's view on financial and performance information.

Overall, performance information was the focus for this group and was definitely used for decision-making with such information being sourced predominantly from annual reports, budget papers, Treasuries, government departments and/or agencies.

The major issue with the current performance information was reliability – it isn't deemed to be reliable because it isn't audited or verified in any way (however, some audit does occur in WA in terms of relevance, appropriateness and presentation of performance indicators published and Victoria). The other impediment to the widespread use of performance information is that a substantial proportion of KPIs are not consistent year-on-year, which

¹ Australasian Council of Auditor's-General (ACAG) response to the Public Sector Centre of Excellence's call for member comment on its Financial and Performance Reporting Project (March 2005).

makes trend analysis and comparatives very difficult. Finally, it was noted by all that performance information does not measure government outcomes, as it should.

A common theme in all the research undertaken is that financial information should not be assessed or relied upon in isolation. Financial and performance information need to be interpreted together for a comprehensive and complete picture of outcomes achieved by an entity.

The CoE has recently engaged a leading public sector academic to develop a discussion paper on this issue. It is anticipated that a draft will be available for comment by the end of 2005. We would be pleased to provide you a copy of our findings of comment and/or information at that time.

Response to Submission

General Information To Assess The Integrity, Economy, Efficiency, Effectiveness Of Government Financial Management

A useful starting point to note is the different objectives of the private and public sectors, in order to establish the context of financial reporting. The objective of both sectors is to generate a return on investment for a given level of risk. However the type of return and the risk tolerance differs between both sectors. The main objective of the private sector is to generate financial returns for the shareholders' investment in the company (financial return on investment).

The main objective of the public sector is to generate social returns for the community from taxes. The tolerance for risks is much less in the public sector - there is little tolerance for failure of public sector organisations, particularly those which use tax funds, or where tax funds are needed to prop up a failed public sector venture/business. Standard financial statements provide information on financial returns, but not social returns. Therefore, it is not possible to assess the economy, efficiency or effectiveness of a public sector agency just from the financial statements. However, financial statements do provide important information about the integrity of financial management of an agency.

At the Commonwealth level and in most States, agencies are required to report revenue and expenditure by output. The information does not give any indication of integrity, economy, efficiency and effectiveness and in fact it does not indicate an operating result, this must be calculated by the user. While this is not difficult, merely a subtraction of expenses from revenue, it does indicate a broader reluctance to provide financial data which might allow the reader to make a judgement on efficiency and effectiveness. It must also be noted that if the information is reported as part of the financial statements it must be of a quality which is auditable, and this may be difficult.

In the Commonwealth, the Finance Minister's Orders (for the 2004-05 financial statements) have extended the definition of materiality as follows:

- 1G *Materiality*
- 1G.1 *The requirements of this policy apply where information resulting from their application is material. Information is material if its omission, misstatement or non-disclosure has the potential to adversely affect:*
 - (a) *decisions about the allocation of scarce resources made by users of the entity's financial report, or*
 - (b) *the discharge of accountability by the entity.*
- 1G.2 *Any material classes of revenues, expenses, assets and liabilities not specified in Appendix A of this Schedule must be disclosed in the notes separately under the*

heading to which they relate unless they are shown on the face of the Statement of Financial Position or Statement of Financial Performance.

- 1G.3 *Any immaterial classes of revenues and expenses not specified in Appendix A section may be included in a class described as 'other' under the heading to which they relate.*
- 1G.4 *The line item for "Other" under revenues, expenses, assets, liabilities, commitments and contingencies should not exceed 10% of the total value of that category.*

This extended definition will go some way to addressing the issue of effective and efficient use of resources. However, the application of this policy in the annual statements is yet to be demonstrated.

Information Availability To Assess Specific Public Sector Performance

We are of the view that there is little information available to assess performance, however, there is very useful information regarding financial risks (such as the funding of liabilities). There is an abundance of data regarding the amount spent on items in a specific year but there is no information on effectiveness, nor is there any time series data which is crucial given that a number of projects that extend beyond one or two financial years. For example, additional funding to reduce hospital waiting lists may not have any impact on morbidity or the health standard of the general community.

Local government in NSW goes through a very public process each year of exhibiting its Management Plan for the ensuing year. The Plan includes objectives, financials, KPIs and other information. The Plan is adopted following community input, often involving public meetings, and is reviewed in a public Council meeting each quarter. There are statutory obligations as to when and what's presented but it's the style of reporting and how the key messages are taken to the Council, community, business, and other organisations that determines the impact.

Usefulness Of Annual Reports And Other Financial Reports

An analysis of existing annual reports would indicate that the financial information is reported in accordance with the accounting standards and has very much a commercial focus with words such as "net surplus/(deficit) from ordinary activities" and "net assets". The use of this terminology has little relevance to organisations operating in a non-commercial environment, associated with the delivery of programs or the provision of policy advice.

The for profit sector uses financial information to demonstrate efficiency and effectiveness by analysing and reporting return on equity profit margins, liquidity ratios and movements between financial periods.

Most indicators are inappropriate for the public sector. For example, the public sector recognises revenue when it is appropriated not when it is earned therefore, in reality there is the potential that revenue reported in one period will not match expenditure which may be incurred in a subsequent period. As a result, the agency reports a profit in one year followed by a loss in the next, an outcome which does not reflect the performance of the organisation. The use of "profit" or "surplus" and the application of this result to determine a return on equity is irrelevant in the public sector. There maybe some benefit in having some private sector indicators at the local government level however, local government performance measurement may be inhibited because of grant funding from State and Commonwealth agencies.

Accessibility And Interpretation Of Performance Information

In most annual reports process data will be available for example, number of beneficiaries paid, time taken to pay invoices, time taken to respond to ministerial correspondence, number of ministerial briefings and amount spent on a particular activity. There are instances of limited information on performance which isn't always easily located.

To achieve greater accountability and linkage between performance and funding, performance measures need to be reported on which cover the full range of matters in an agency's strategic plan and this should be subject to audit.

The use of triple bottom line data and sustainability reporting is one way of enhancing this but it is gradually evolving, at a very slow pace.

Sustainability Reporting

Sustainability involves an examination of entities across three pillars of governance - social, environmental and economic, and in the government sector is used interchangeably with the term triple bottom line reporting (TBL).

Whilst the private sector has taken the lead so far in social and environmental reporting, there is an important role for government. Sustainability reporting in the public sector should be considered on two fronts – as a jurisdiction (a government as custodians for natural, built and social capital on behalf of community) and as an organisation (the government body use of resources, generation of wastes and management of staff). This fundamentally separates the public sector from the private sector. While the credibility and usability of sustainability reports may enhance reputation, the private sector can use sustainability reports to influence the market, while the public sector as arguably a perpetual entity, can use sustainability reports to report to the community on its stewardship.

Interest in sustainability/TBL reporting has risen in prominence even more so recently due to a number of factors; growing interest from the International Federation of Accountants (IFAC) on sustainability and enterprise governance; large government departments such as Family and Community Services (FaCS) producing its first TBL Report in 2002-03; Department of Environment and Heritage's recent investigation into Corporate Sustainability (The Mays Report); and Canada issuing its annual 'Sustainability Report' with some of the specific issues encompassing, how will changes in sustainability affect health, economic situation and enjoyment of life; what are sustainable levels of consumption and pollution; and what kind of legacy is being created for future Canadian generations.

The Global Reporting Initiative (GRI) is often cited as the non-mandatory framework which is the basis behind successful corporate sustainability reports. The GRI framework promotes high quality reporting of social, environmental and economic performance by all types of organisations. The GRI seeks to promote consistency and comparability of sustainable reporting by defining a minimum set of non-financial indicators and policy areas to be addressed in a TBL type report. Indicators of progress are expressed in a mixture of quantitative metrics or even qualitative terms.

The GRI provides:

- A comprehensive introduction and approach to sustainability reporting;
- Sector specific guidelines for both private and public entities;
- Protocols for specific performance indicators;
- A basis for credibility of reporting that is needed by exporters and companies with overseas shareholders; and

- An opportunity to report corporate performance in the context of important national and regional issues.

The GRI guidelines are founded on principles similar to those of financial reporting, which makes the transition from conventional reporting a much simpler process. The guidelines can also be implemented incrementally over a number of years, easing the uptake of new reporting processes. The GRI focuses on disclosure that is, how an organisation discharges its accountability to its stakeholders for disclosing non-financial performance in areas of economic, social and environmental impact and risk. It promotes; sustainability reporting, use of a common reporting framework and achievement of high reporting standards. It also seeks to elevate sustainability reporting to the same levels of credibility, comparability, rigour and verifiability expected of financial reporting.

More than 400 organisations currently use the guidelines. In the past year the GRI has launched sector supplements which tailor the reporting guidelines to the needs of specific sectors. The public sector supplement was released in September 2004.

Linkage Between Financial Information In Annual Reports And Management Information

Most management reporting and analysis undertaken is usually around actual versus budget and usually on a cash basis. We believe there is little commentary on the balance sheet or accrual expenditure. What is required is more and robust management discussion and analysis (MD&A).

Management Discussion and Analysis (MD&A)

Department of Treasury and Finance (ACT) issued better practice guidance on MD&A in May 2004². The guidelines state that the purpose of the MD&A is to enhance financial reporting, mainly in the annual report, by providing a high level overview of the financial results and health of an agency. An MD&A should provide a historical and prospective analysis of the reporting entity, through the ideas of management.

The management of an agency should be in a position to explain the significance of key financial information contained in the financial statements, the strategies that led to the results reported and the implications of financial trends for future services/operations of the agency. Provision of this information assists users of the financial statements to more completely understand the information presented.

The MD&A should be understandable and useful to a wide audience, including the Legislative Assembly (such as the Public Accounts Committees), which predominantly consists of non-accountants. The MD&A information precedes the audited financial statements in the annual report, but does not form part of the financial statements and as a result is not directly subject to audit. The guidelines identify a model framework for MD&A in State and Territory annual reports.

Usefulness Of Budgeted Figures In Financial Reports

Budget comparisons are important but changes to budgets during the year in response to changing needs or opportunities need to be acknowledged and/or allowed for when comparing figures.

² Department of Treasury and Finance (ACT), "Management Discussion and Analysis – Better Practice Guideline", May 2004.

Budgets tend to be input focussed and there is limited information on performance except in the areas of processing for example the number of beneficiaries or ministerial briefings. Performance measures may be inhibited because outcomes are not easily measurable and outputs are input driven. Portfolio Budget Statements for every portfolio at the Federal level must include (and do) performance indicators on the effectiveness (including quality of outputs/outcomes) and efficiency (price of outputs). There are questions however, as to how adequately the reported indicators meet these requirements in some cases.

Introduction Of AIFRS

The aim of AIFRS is to improve the consistency, comparability and transparency of information included in financial reports, regardless of the type of entity and where the entity is located. Should it achieve these objectives it is likely that the transition to AIFRS will improve the usefulness of information included in financial reports.

As most government entities are at present still in the early stages of identifying changes required under AIFRS from 1 January 2005, it is difficult to assess what impact the move to AIFRS will have on financial reporting by government entities.

There will potentially be problems with the practical application of AIFRS and the overall impact for decision making such as; the calculation of embedded derivatives, the splitting of annual leave into current and non current and discounting the non current liability.

Conclusion

In summary, we wish to bring to your attention the following three key areas:

- Sustainability reporting - whilst the private sector has taken the lead so far with respect to sustainability/TBL reporting, there is an important role for government. The Global Reporting Initiative (GRI) is often cited as the framework which is the basis behind successful sustainability reports. The GRI guidelines are founded on principles similar to those of financial reporting and focus on disclosure of non-financial performance in areas of economic, social and environmental impact and risk;
- Management Discussion and Analysis (MD&A) – the purpose of the MD&A is to enhance financial reporting, mainly in the annual report, by providing a high level overview of the financial results and health of an agency. An MD&A should provide a historical and prospective analysis of the reporting entity, through the ideas of management; and
- CoE research and experience - has indicated that financial information on its own is less meaningful than when combined with performance information.