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The Research Director
Public Accounts Committee
Parliament House
George Street
BRISBANE QLD 4000

Dear Madam,

Inquiry - "Government Financial Reporting"

The Australian members of the Australasian Council of Auditors-General (ACAG) have been canvassed and submit the attachment in response to your Committee's Discussion Paper on the above and invitation to make submissions.

The attached represents the views of all Australian members of ACAG except for
- the Auditor-General of Queensland who will provide a separate submission; and
- the Auditor-General for South Australia who reserves his right to respond separately where he deems it appropriate, rather than as a member of ACAG.

The opportunity to provide comment is appreciated and I trust you will find the attached useful.

Yours sincerely

[Original Signed]

H M Blake
Chair
ACAG Advisory Committee
18 July, 2005

AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL

(Limited to those ACAG Offices referred to in the attached covering letter. Any reference to ACAG below relates only to those ACAG offices participating in this submission)

Submission to the Queensland Public Accounts Committee Inquiry into Government Financial Reporting

(July 2005)

Introduction

We note that the Committee has resolved to undertake an inquiry into whether stakeholders can readily assess the integrity, economy, efficiency and effectiveness of government financial management through the current financial reporting regime.

Since the members of our Council participating in this submission are not stakeholders in Queensland's financial reporting regime we cannot provide insights as users of the resulting financial reports. However, we believe it would be useful to provide the Committee with what our members see as some of the more significant emerging trends in government financial reporting.

Our submission covers the following topics:

- New Reporting Models
- Increased Focus on Outcomes
- Management Discussion and Analysis
- Shorter Reporting Time-frames
- Renewed Focus on Systems and Controls
- Expectations of Public Sector Audit
- Accounting Standards for the Public Sector
- Specific Issues the Committee wishes Respondents to Consider

New Reporting Models

There is increasing recognition that financial reporting on its own is often of limited value. This is particularly so in the public sector where finances are a means to an end rather than an end in themselves. For example, financial reporting does not measure the quality of services or assets provided to a community by the government. The financial consequences, while important, are generally secondary to the outcomes achieved.

Issues such as the availability and sustainability of infrastructure, the quality of education, or the availability of health facilities have a direct impact upon the well being of the population and are not reflected in traditional financial reporting.

Similarly, government can have a significant impact upon the environment, both in terms of the overall policy agenda as well as through its internal management practices. Also lacking from the financial reports is any measure of intellectual and human capital which can be significantly impacted by government policies and actions.

Within the foreseeable future it is likely that we will see new or better ways of representing and reporting this type of information. One example is the so-called Triple Bottom Line (TBL) or Sustainability reporting which seeks to provide information about the economic, environmental and social performance of an entity.

Private sector corporations are increasingly realising that TBL reporting improves the way they are perceived by the investment community. There is increasing interest and uptake by governments as well. Standards are being developed for the preparation and presentation of these reports.

This is not to say that financial reports do not have a stewardship or accountability role. They will continue to be important from this perspective but can be expected to be supplemented by new reports which seek to provide more comprehensive reporting.

Increased Focus on Outcomes

There is a clear international trend towards more emphasis on the result of spending as well as the cost. And there is a growing recognition that management needs quality information on all aspects of performance: outcomes, programmes, outputs, activities, processes and inputs and the relationship between them. In the early stages of implementing performance measurement and reporting regimes many jurisdictions placed more emphasis on outputs and efficiency. More recently, jurisdictions have begun to place greater emphasis on outcomes and the relationship between outputs and outcomes.

A typical outcomes and outputs framework helps answer three fundamental questions:

1. What does government want to achieve? (outcomes)
2. How does it achieve this? (outputs)
3. How does it know if it is succeeding? (performance reporting)

The issues being encountered include the difficulty of identifying relevant and appropriate performance indicators and the problems associated with the new environment of greater collaboration and partnerships across agencies, across levels of government and between government and private sector not-for-profit and for-profit organisations. Particular areas which ACAG members typically note as needing improvement include:

- outcome statements are often at a very high level and do not identify clear, specific results and explicit impacts.
- links between outcomes, outputs and performance indicators are not always clearly demonstrated.
- links between outcomes, outputs, performance indicators and financial reports are not always clearly demonstrated.
- agencies need to specify better their contribution to shared outcomes.

Remedying these deficiencies would improve significantly the usefulness of financial and performance reports for both accountability purposes and for management decision-making.

Management Discussion and Analysis

Management discussion and analysis (MD&A) is narrative disclosure by the management or governing body of an entity which expands and explains the information provided in the financial statements. The MD&A is usually a discrete part of the annual report. MD&A reports are designed to supplement and enhance general purpose financial reports and have been a feature of corporate sector reporting for some time but less so in the public sector.

The MD&A should assist the user's understanding and assessment of the performance of the organisation by setting out managements' analysis. There are a number of publications providing guidance on the MD&A, including those by the Group of 100 and the Canadian Institute of Chartered Accountants. These suggest that the analysis and discussion should be framed within five key elements, being:

1. the organisation's vision, its key objectives and strategies;

2. key performance drivers;
3. capabilities to achieve the desired results;
4. results - historical and prospective; and
5. the risks that may shape and/or affect the achievement of results.

Some of the essential features of an MD&A are:

- it enables readers to view the organisation through the eyes of management
- it is written in a plain language and is easy for users to understand
- it complements and supplements the financial statements
- it draws together and relates financial and non-financial performance indicators and measures.

Shorter Reporting Time-frames

In the Australian public sectors we are seeing increasingly shorter time-frames for annual reporting. This follows a similar trend in the corporate sector for quicker reporting and "continuous disclosure" of material matters.

The trend suggests that the business reporting model of the future is online, real-time disclosure. The business marketplace is demanding more relevant, up-to-date information using technology formats that allow quick access and analysis to help make better decisions. Evidence shows those companies best able to respond are rewarded in the marketplace. There are benefits to be gained even at the stage where the reporting is internal only.

This future is made possible by technological developments such as the internet and the emergence of XBRL, a computer language that allows those using information to prepare, publish, exchange and analyse financial and other information easily, quickly and cost-effectively.

While governments are unlikely to experience the same external pressure as the corporate sector, the demand for online, real-time disclosure is inevitable.

The fundamental elements that need to be in place to provide reliable online, real-time reporting are:

- a recognition of the benefits of earlier availability of relevant financial information
- reliable systems
- a common method of disseminating information
- robust corporate accountability, governance and risk management frameworks
- "understandable" disclosures of financial statement information (relevant, valuable, easy to understand).

Renewed Focus on Systems and Controls

The major corporate failures in recent years have focused intense concentration on issues of financial disclosure, corporate governance and the practice of auditing. The main legislative reaction has been in the US with the introduction of the Sarbanes-Oxley Act. Trends which are apparent:

- with the globalisation of commerce the impact of Sarbanes-Oxley extends well beyond the US;
- implementation of the Sarbanes-Oxley requirements has resulted in extra cost (which has concerned the corporate community but, so far, been generally accepted by the investment community);
- there is likely to be some winding back of the requirements;

- the statutory requirements could be extended to the not-for-profit sector in the US (in recognition of the fact many face issues similar to those which affected publicly-traded companies);
- there is some suggestion that private companies (which are not subject to Sarbanes-Oxley) are adopting what they see as the "best business practice" aspects;
- there is increasing interest in the cost of fraud in the public sector and the adequacy of fraud prevention measures.

To the extent that Sarbanes-Oxley requirements become seen as good practice those aspects may well be adopted by public sectors. Of particular relevance to this inquiry are those relating to the integrity of financial management and would include the provisions relating to:

- audit committees (Section 301)
- corporate responsibility for financial reports (Section 302)
- Improper influence on conduct of audits (Section 303)
- management assessment of internal controls (Section 404).

Expectations of Public Sector Audit

The mandate of public sector auditors in Australia is set out in legislation and varies amongst the States, Territories and the Commonwealth. All are required to provide audit assurance regarding the financial reports of government and government agencies. All except two have a full performance audit mandate. (Queensland is one of those which does not.) Two (WA and ACT) are also required to report specifically on key performance indicators published by agencies. Furthermore, for some (Queensland included) the audit mandate encompasses local government bodies.

The following observations may be relevant to the Committee's present inquiry:

- An increasing requirement for performance audit work. (In the last three years a number of ACAG members have either been given for the first time a mandate to undertake performance audits or been provided with an increased capacity to undertake performance audits.)
- An increasing recognition of the value of audit assurance in respect of performance indicators and measures. (This is probably a result of the trend mentioned earlier towards stakeholders placing a greater focus on outcomes and on the measuring of performance in non-financial terms.)
- Audit concentration on agency control structures. (Public sector audit has typically had a strong focus on internal controls with audit reports generally including reference to weaknesses or breakdowns which have been found or, in some cases, providing an overall assessment of an agency's control systems and control environment. Recent corporate collapses have reinforced the importance of audit attention to this aspect. The Sarbanes-Oxley requirement for the auditor to report on the effectiveness of internal controls reflects what has been public sector practice for some time.)
- There is a general expectation by stakeholders that audit be more forward-looking. (This has been given expression in at least two of the ACAG members' jurisdictions with the requirements to report on prospective information such as budgets and forward projections. There is also increased recognition of the preventative role which audit can perform through identifying and publicising examples of good practice.)

Accounting Standards for the Public Sector

Globally the accounting profession is moving towards a common set of accounting standards with Europe, Australia and New Zealand committed to International Financial Reporting Standards (IFRS) and the US and Canada having set longer-term goals of convergence of their standards with IFRS.

Clearly the aim of IFRS is to improve the consistency and comparability 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 IFRS will improve the usefulness of information included in financial reports.

Of concern to ACAG members is that IFRS have a strong private-sector orientation and the standard-setting process locally gives priority to private sector issues. It is increasingly apparent that areas which warrant the development of an accounting standard to meet a public sector need are unlikely to be dealt with by the Australian standard-setters in what we see as a reasonable time-frame.

ACAG is presently working with its Treasury counterpart (HoTARAC) to agree a prioritised list to present to the Australian standard-setters. The list is likely to include such issues as:

- Resolution of the GFS and GAAP convergence project (so that the public sector has a stable basis for accounting standards)
- Accounting for public/private partnerships (this is becoming urgent because of the number of large-scale PPPs being proposed around Australia)
- Determining whether an entity is 'for profit' or 'not-for-profit' (under IFRS the distinction has a significant impact on the accounting result)
- Non-financial performance reporting (important for reasons mentioned elsewhere)
- Reporting by government departments and by government-as-a-whole (the existing standards are increasingly out of date since the introduction of IFRs and with changing public sector practices).

However, the most likely outcome (given the Australian standard-setters' heavy workload with the introduction of IFRS) is that any work which the public sector wants the standard-setters to address in the near-term will need to be resourced or funded specifically by the public sector. In this regard there may be a role for the Public Accounts Committees to play should they, individually or collectively, consider that action by the Australian standard-setters would resolve issues such as those mentioned in your Discussion Paper; for example the usefulness of public sector financial reports, availability of information to assess the economy, efficiency and effectiveness of government operations, understandability of performance information, etc. Some assistance may be available through the work of the International Public Sector Accounting Standards Board which develops standards of relevance to the public sector.

Specific Issues the Committee wishes Respondents to Consider

Whether the current reporting regime enables stakeholders to readily assess the integrity, economy, efficiency and effectiveness of government financial management and if not, what improvements could be made.

We again stress that we are not stakeholders in the Queensland reporting regime and do not presume to know how it is viewed by those who are. However, we would suggest that the following aspects drawn from our earlier comments, could be considered:

- the reporting models now emerging incorporate financial reporting within a broader framework, typically including economic, social and environmental aspects also
- there is a trend towards greater emphasis on reporting outcomes
- an accompanying management discussion and analysis (MD&A) can supplement and enhance financial reports and relate financial to non-financial information

- an audit function with a broad mandate provides added assurance regarding financial management.

What information is available to assess the economy, efficiency and effectiveness of government operations in general.

Our view is that the matters listed immediately above could be considered in relation to government operations in general.

What information is available to assess specific public sector entity performance.

We believe that the matters listed immediately above could be considered in relation to specific public sector entity performance.

How useful are annual reports and other government financial reports.

The matters listed immediately above could be considered in relation to annual reports and other government financial reports. In addition, our earlier comments regarding expectations of increasingly quicker reporting time-frames are relevant.

Is performance information readily accessible and can it be interpreted by non-expert users.

The following might be considered some of the pre-requisites for ready accessibility and ease of understanding:

- timely reporting
- availability of information in electronic, hardcopy and web-based formats
- conformity to recognised standards of reporting based on the needs of users
- supplementation of financial and quantitative data with management discussion and analysis.

Is the financial information presented in annual reports linked to management reporting.

We consider that it should be.

Do audited financial statements meet performance needs or do they only address compliance.

We consider that they should meet both.

How useful are budgeted figures in the government financial reporting process.

Where the budgeted figures represent Parliament's appropriation of funds to certain purposes, those figures are important as a control function. Where the budget figures represent targets, they are important in order to measure financial performance. In either case, usefulness depends on a clear understanding of what purpose the budget figures are intended to serve. We note that both the AASB and the IFAC's PSC are developing accounting standards for budget reporting by the General Government Sector. This is a development that ACAG supports and will be commenting on.

Will the introduction of international accounting standards provide more meaningful information about a public sector entity's performance.

The introduction of IFRS standards produced by the International Accounting Standards Board should improve the consistency and comparability of information included in financial reports regardless of the type of entity and where the entity is located. That, in turn, should improve the usefulness of information included in financial reports. However, it is more likely that the impetus for improvement in performance reporting (other than financial performance) will need to come from another source which has more of a public sector focus.