

National Public Sector Accountants Conference

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Panel Session Day One:

How will the adoption of Accrual based accounting affect Stakeholders and Society in General?

Affect on Citizens and the Auditor-General – Presented by: Mr. Wayne Cameron FCPA

Introduction

The application of accrual based accounting methods to the core public sector in an ever increasing number of countries around the world has been the subject of much discussion – mostly at conferences such as this and by accountants who have been tasked with introducing the change from what typically is a cash based accounting and reporting system. That is not to say that the adoption of accrual based accounting systems is not desirable and necessary. We here present today and a great many other stakeholders will agree, that the use of accrual accounting represents a great improvement on cash based recording and reporting systems. But does the adoption of accrual accounting have any significant affect on stakeholders and society- that is the issue the panel has been asked to consider. It is my allotted task to outline my observations of the application of accrual accounting to the public sector as it affects the Citizens and the Auditor-General. It's my assessment that it has impacted on both constituencies - but in quite different ways.

Affect on Citizens

Before coming here this week I was telling to my eldest son, who has a successful building business, that I was travelling to Kuching to speak about accrual accounting. I half expected that he would simply say that I would enjoy the trip and meets lots of nice new people. But he surprised me with his response. He said "Accrual accounting – that's the correct way of measuring and reporting what actually happens isn't it Dad?" I have to say that I was both pleased and impressed with his response. You see, I thought that only Accountants understood what accrual accounting means. What his response taught me was that citizens from all walks of life are likely to understand what all this talk about accrual accounting is – when explained in their terms. It's only when we start to use jargon like IFRS and IPSAS that they look for something else to do.

The affect on citizens will largely be governed by what and how the media report on government finances to the community. It therefore depends upon how well the media understand the financial information made available to them. So there is a training issue for public commentators that needs to be addressed as part of any change in measuring and reporting. It will also depend on what level of reporting is under discussion. What is key information at a national level might be quite different

at the local level. For example – any proposed rate increase or the Capital Works programme and how it is to be financed is a key point of focus in local government. While Government’s ability to balance income and expenditure levels, sustain existing programmes and meet growth demands is of greater importance for national Governments. Interest at Ministry or Departmental level tends to be around service levels and adequacy of accountability.

It is well understood that citizens are mostly concerned about how a nations’ financial state affects them. They therefore are concerned mostly about the likelihood of changes in taxes and other government imposts. They will be concerned about possible changes to the delivery of existing government programmes and services and they will be interested in the level of government debt since the government’s level of public debt will affect interest rates. I think also – drawing on the lesson learned from the discussion with my son – the community does want to know that its Government is maintaining good quality and appropriate financial managements systems. Most citizens recognise that reporting what is banked and what is paid is not enough to judge financial performance and financial position. They know from their own experience that expenses are incurred when transactions occur, that assets decrease over time with use and that liabilities have to be serviced. Accrual accounting is accompanied by a range of different factors which impact on the measures that the community use to judge the performance and financial position of Government.

There are some quite big differences between the cash based information and accrual. All of which will require consideration in relaying and explaining to the community. Let me draw on some examples of what I have in mind.

- ***Explaining fluctuations in results flowing from revaluations and impacts from changes in accounting policies.*** The adoption of accrual based principles is accompanied by the need to revalue assets and liabilities and reflect that change in the Statement of Financial Performance. In Government these revaluations can be extremely large and especially so on initial adoption. Examples that spring to mind are the revaluation of student loans often downwards, movements associated with revaluation of government Investments and Public Debt, revaluation of Liabilities such as insurance liabilities or significant transactions related to realisations from sale of large government assets. Significant changes in any one of these areas has an enormous impact on the reported operating result and requires explanation. It is for this reason that the New Zealand Government over the past decade or more has adopted variations of a measure that focuses on a “normalised” (called OBEGAL¹) operating result when discussing the financial results in accompanying narrative to the Government’s Public Accounts. The OBEGAL result is of course reconciled back to the accrual result in a transparent manner so that there can be no suggestion that the figure of greater focus by the Government is somehow “made up” by government to show things in a better light. The private sector does the same in discussing OBITDA² results, at times, in preference to the reported operating result.

¹ Operating Balance before Gains and Losses. These adjustments comprise movement in actuarial valuation of ACC & GSF, revaluation movement in Investment portfolios (NZ Super Fund, ACC, EQC) and other movements such as revaluation of Public Debt.

² Operating result before interest, taxes, depreciation and amortizations

The same issue around “normalising” is also true for changes to reported outcomes that arise out of changes in accounting policies including changes in impacts arising out of changes in treatments where there have been changes to the Accounting Standards themselves. The impact of such changes in the New Zealand setting is teased out in the explanatory notes accompanying the Financial Statements as required by the Standards.

- **Reporting budget outcomes.** One of the issues that has not been accommodated in International accounting standards has been the failure to recognise the fundamental importance of the Government Budget sector. For most, the Budget sector is the embodiment of Governments’ financial plans and accountability. Yet the accounting standards (I refer to IFRS here) focus on determining a consolidated result and position for an entity. The problem with that in Government is that Government is made up of many parts, some core government policy delivery ministries, some crown entities and some large state trading bodies. Each play their own part in the Government’s financial picture but when all consolidated together, accountability for budget outcomes is lost unless special steps are taken to display the budget sector separately as occurs in Australia. It is hard enough to get Economists to accept reports on an accrual accounting basis anyway for the Budget sector – they traditionally use the GFS (Government Finance Statistics) basis which ties in with the SNA series used in international comparisons – without denying them financial data about the Governments Budget sector.
- **Consolidated Results.** IFRS and IPSASB require full line by line consolidation of income, expenses, assets and liabilities to be reported in the Financial Statements of an entity, including Government. It is not hard to understand why the consolidated picture is important in the private sector. There the focus is on aggregate distributable income available to shareholders and aggregate wealth as reflected in the total net equity figure in the Statement of financial position. In government however, there are different elements of the government’ financial picture for the community to understand. An aggregate picture covers up the performance of the Budget sector and does not allow a reader of the Public Accounts a chance to see clearly how well other parts of government are performing. It’s for this reason once again that New Zealand initially deferred full consolidation on a line by line basis of all of its many constituent bodies until it was satisfied that the consolidated picture would convey meaning and transparency. It believes it has now achieved that balance by reporting a disaggregated picture comprising 3 key sectors of government: Budget Sector, Crown entity sector and State Trading (SOEs) sectors.
- **Understanding provisioning against loss in value of certain assets.** We all know that as accountants we need to test the veracity of the underlying value of an asset and if the carrying value of the asset is diminished a provision for possible loss on realization must be made. However in the public sector there are some unique assets which have a legislative backing making them fully collectable by force of law. Examples that come to mind are court fines, taxes, rates struck by local governments, loans to individuals such as students by the state. In making the change to accrual accounting an estimate of the likely collection value of debts due to the state is required, leading, initially at least, to a quite substantial provision being made for such statutory debts not being collected. This new information provided can

lead to concern by the citizens that fines, taxes etc. are not being paid as they should be. That concern may be expressed as a loss in confidence in the governments' willingness to pursue debts. Care will be required to explain the underlying reasoning for any write down in value of such statutory debts if public confidence is to be preserved.

Affect on the Auditor-General's Office

I can speak to this element of the presentation with 20 years of personal experience both in New Zealand and in Australia. The Auditor-Generals' Office is not without experience in undertaking the audit of entities which prepare their Financial Statements on a full accrual basis. In so many countries the State's trading bodies (such as airlines, shipping companies and energy companies) will have been using accrual accounting for many years. In some instances the auditor may also have been auditing entities that have been applying International Accounting Standards. So the concepts and practice of accrual accounting will already be well understood by the Auditor-General. What is new and challenging is the application of accrual accounting to the "core" public sector. So what are the challenges?

- **The need to build capacity.** Although some staff will have knowledge of accrual accounting, the unique nature and volume of issues that need to be considered not just at year end when the first audit of accrual Accounts is undertaken but as soon as preparers commence considering the issues that the first time application of accrual accounting to the core public sector require will place enormous strains and expectations on audit staff. I should add that it does the same to the auditee as well so there is in fact a one-time massive increase in demand by public sector agencies for skills and advice. Because it is a one-time peak in demand for these skills, Auditors and Auditees alike may need to consider supplementing their in house skills and knowledge with contract supply from the private sector. Some of this contract supply of supplementary capacity can be applied in a number of ways. My view always was to ensure that one builds up the skills and knowledge of staff. It was always therefore better to use contractors to provide a mix of services – training of staff as well as assistance in problem resolution of issues.
- **Adopt Leadership role.** The Auditor-Generals Office often has the greatest public sector experience in the application of accrual accounting in the public sector. Use that knowledge. Central agencies will look to the Auditor-General for support and leadership. Ministers will look to the Auditor-General for leadership as will the agencies themselves. In the first year or so the auditor cannot afford to wait until year end to determine their view on an acceptable accounting treatment. They will need to anticipate issues and establish a regular liaison with the lead central agency – the Department of Finance. In New Zealand and Australia all Financial guidelines and technical bulletins will have been agreed and cleared between Treasury and Audit before dispatch to agencies. In my early years in Victoria I became concerned about the same issues being raised by different agencies, running the risk that different solutions were applied thus undermining the credibility of the move to accrual accounting. Where the issue was technical we sought a response by the Department of Finance and often a technical bulletin resulted but issues around display kept coming to attention. The solution! I asked my technical group to prepare "model" sets of Financial Statements for 4 key agency groups; viz Departments, Local governments, Hospital

authorities and Education institutions. It didn't solve all problems but I can say that it wiped out almost all issues around presentation overnight. I understand that the Department of Finance now prepares and makes available these Model Accounts.

In the first 2 years or so agencies will look to the auditor for help in resolving technical issues. Usually the Department of Finance is also vitally interested in resolution of such issues too, so the auditor will need to bring matters to the attention of the central agency as soon as they come to notice. The auditor is one of the few parties to the whole process that sees what is actually happening on the ground. So they have a unique and useful contribution to make in making sure that guidance is provided to agencies in a timely as well as consistent fashion. Often Departments of Finance will issue regular newsletters to agencies setting out what is required, how and by when. The auditor should never find themselves of being in a position that those newsletters or bulletins contain guidance which they disagree with. If the auditor has a difference of view it must be sorted out with the Central agency before the position is promulgated publicly. Later of course those early newsletters or bulletins become reflected in a body of reference material such as a manual – most of which in now days available via a web portal.

- **Extra audit in first year of Adoption.** Planning within the Auditor-Generals' office will need to factor in an extra audit in the first year of adoption. Opening accrual balances will need to be established and audited. This is best done as early on in the accounting cycle as possible. It will be far too late to try and cover this aspect of the audit as part of the year end attest cycle. Some considerable effort applied at this stage will be well spent and will minimise year end audit issues. Issues that arise at this stage include; issues around defining the entities that will need to be consolidated into the Public Accounts – some for the first time issues around the adequacy of underlying records for assets and liabilities and issues around confirming appropriateness of interpretation of applicable accounting standards.
- **Problem resolution service.** There will be a range of issues that need to be addressed on first time conversion to accrual accounting. A number of these will be covered in my presentation tomorrow morning so I won't go over them now. But as part of the shift to accrual the Auditor-General will need to gear up for resolving a large increase in technical issues, the resolution of which will require much more liaison with other and research. In Victoria I established an open ended contractual arrangement with a highly regarded technical accountant to assist resolving technical issues. Quite often those technical issues required a great number of meetings not only in house but with the Department of Finance as well. One such example that springs to mind relates to determining the accounting treatments for Public Private Partnership transactions.

The interesting side issue for us in New Zealand was to watch our most skill personnel being recruited by the Treasury to assist in the drafting of the new Public Finance Legislation and in the subsequent roll out of accrual across the core public sector. So be prepared to lose some good people. The up side is that you have someone on the auditee side who understands the audit requirements.

- **Additional Assurance to Parliament.** There will also be an expectation from Parliament to hear from its servant, the Auditor-General, how well the change in accounting systems, procedures and practices was managed by government and its agencies. It will also want to hear whether the change and additional demands on resources has or is likely to lead to improved government reporting and better management of state resources, is likely to result. My passing comment is that a change in accounting systems on its own is not likely to lead to better resource management. The changes that lead to better resource management may well result from the availability of better, more timely information, but it is more likely that real improvement is driven by commitment to improvement and incentives being made available that reward improved efficiency and effectiveness.

Thank You.