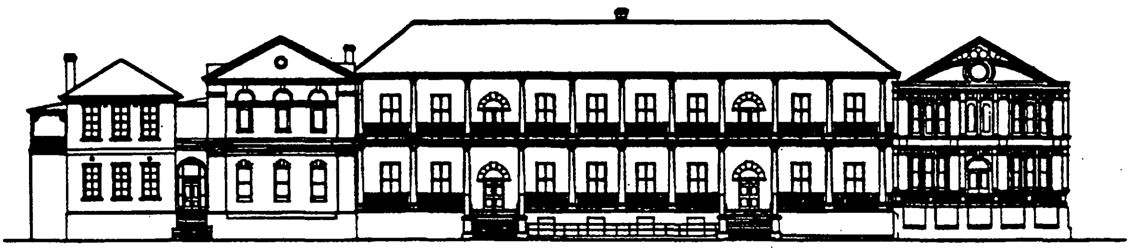
PUBLIC ACCOUNTS

COMMITTEE

PIONEERS - PROGRESS BUT AT A PRICE IMPLEMENTATION OF ACCRUAL ACCOUNTING IN THE NSW PUBLIC SECTOR



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Public Accounts Committee Secretariat

Patricia Azarias, MPA Princeton, B.A.(Hons) Oxon., B.A.(Hons)
Director

Ian Thackeray, B.Surv., B.A.
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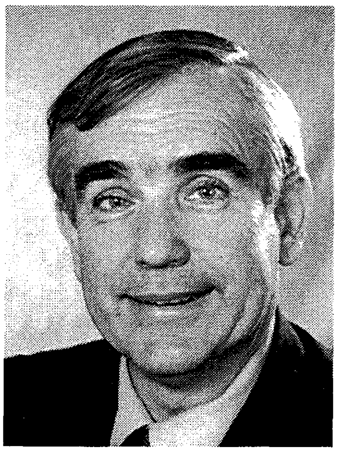
Caterina Sciara
Assistant Committee Officer

John Lynas, FCPA
Accounting and Auditing Advisor
Auditor-General's Office

Ross Kendall, B.Ec.
Temporary Research Officer

Public Accounts Committee
Parliament House
Macquarie Street
Sydney NSW 2000

Telephone (02) 230 2631
Facsimile (2) 230 2831



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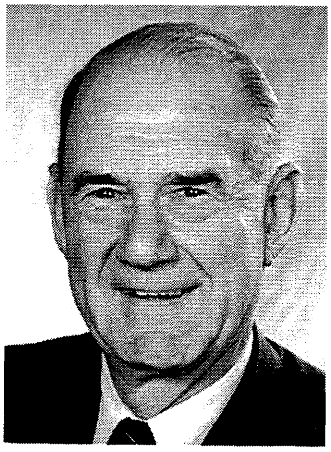

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Member for Northern Tablelands

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Member for Fairfield

MEMBERS OF THE PUBLIC ACCOUNTS COMMITTEE

Mr Terry Rumble, FCPA, MP, Chairman

Terry Rumble was elected Labor Member for Illawarra in March 1988. Before entering Parliament he qualified as an accountant and was employed in public practice and in the coal mining industry. He has served as a member of the Regulation Review Committee and is the Chairman of the Premier's Backbench Committee which involves Treasury, arts and ethnic affairs. Mr Rumble was elected Chairman of the Committee on 24 May 1995.

Mr Pat Rogan, MP, Vice-Chairman

Pat Rogan has been member for East Hills since 1973. He has been active on numerous parliamentary committees in that time including the Joint Committee upon Public Accounts and Financial Accounts of Statutory Authorities. This was the Committee that reactivated a dormant Public Accounts Committee in 1983. Pat Rogan has also served as Shadow Minister for Minerals and Energy with a background as a senior sales engineer in automation.

Mr Joe Tripodi B.Ec (Hons), MP

Joe Tripodi was elected to Parliament in March, 1995 as the Labor Member for Fairfield. Before entering Parliament he worked as an economist with the Reserve Bank of Australia and as a union official with the Labor Council of NSW.

Mr Ian Glachan, MP

The Liberal Member for Albury since 1988, Ian Glachan has had a varied background. He served five years at sea as a marine engineer, was a farmer for ten years, and operated a newsagency in Albury for 18 years. Mr Glachan is also a past president of the Albury-Hume Rotary Club and a Paul Harris Fellow, an active member of the Anglican Church, and was the Legislative Assembly member on the Board of Governors of Charles Sturt University. He was Chairman of the Public Accounts Committee in late 1994 and early 1995.

Mr Ray Chappell, MP

Ray Chappell was elected National Party Member or Northern Tablelands in May 1987. He has worked in university administration and in the building and retail industries, and he served four terms as an alderman on Armidale City Council. During his Parliamentary career Mr Chappell has served as Minister for Small Business and Minister for Regional Development, Shadow Minister, Chairman of several Select Committees and member of the Board of Governors of the University of New England.

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CHAIRMAN'S FOREWORD

This report is a major landmark for the Public Accounts Committee. It is our 100th report since the Committee was reactivated in the early 1980s.

It is fitting that the report should deal with a historic shift in NSW, that is, the change from cash to accrual accounting for budget sector agencies. The Public Accounts Committee was one of the main agents for this change, having recommended in a number of previous reports that it be adopted.

The Government of the day implemented the Committee's recommendation, and the process of adopting accrual accounting went on in NSW for almost five years. It is now virtually complete. NSW is the first jurisdiction in Australia, and one of the first in the world, to adopt accrual accounting for budget sector agencies.

Inevitably with such a large undertaking, especially one which was pioneered, there have been problems, but the Committee is heartened that by and large the process has been a success. Managers say they have derived a tremendous amount of useful material for decision-making from the information given them by accrual accounting. The State has a much better picture of the assets it owns. It knows much more about its revenues and expenditures than it has ever done. Costs that were hidden have emerged into the light. Management of the State's resources has definitely benefited.

The Committee received evidence that the whole process cost about $100m, but this is just an estimate. The Committee tried very hard to establish a figure for the total cost of the adoption of accrual accounting, but it proved very difficult in practice to distinguish costs which were attributable only to accrual accounting from costs which would have been incurred anyway, such as the purchase of computers.

Some of the problems relate to the slow progress of other jurisdictions in this field, notably the Commonwealth, and the Committee would urge other jurisdictions to take note of this report and speed up the adoption of accrual accounting themselves.

The role of the Treasury is still to be finalised. The Treasury provided some training in the adoption of accrual accounting, but the fact that it still requires cash-based information to facilitate reconciliations back to cash budgets and appropriations means that agencies are reluctant to give themselves over fully to accrual accounting and reporting.

When the Commonwealth adopts accrual accounting, some of these problems will disappear.

The Committee looks forward to seeing all other jurisdictions in Australia implementing accrual accounting, and trusts that this report will be of use in that process.

Many people were instrumental in the preparation of this report. First and foremost, I would like to thank Rochelle Bradley of the Audit Office, who, on part-time secondment, researched and wrote Chapters 2 and 5, and a major part of Chapter 4 of this report. She did an outstanding job and the Committee greatly appreciates her contribution. We would also like to thank Kevin Fennell, PSM, former Deputy Auditor-General, who wrote valuable material on asset valuation in Chapter 4; and Jozef Imrich, the Committee's Clerk, who with his usual resourcefulness and willing co-operation, wrote the material for Chapter 3. John Lynas began the project and contributed many valuable ideas throughout.

We would like also to thank the Treasury and all the agencies who so readily filled out a detailed questionnaire, as well as all those who participated in our Seminar, *Accrual Accounting: the Scorecard to Date*, which was a considerable success.

The report was carried out under the direction of Patricia Azarias, the Committee's Director, who ensured co-ordination and final editing. We thank her for her valuable contribution.

Last, but certainly not least, I would like to thank my fellow committee members, Pat Rogan, Joe Tripodi, Ray Chappell and Ian Glachan (and previously Peter Cochran and former Chairman Andrew Tink) who worked so hard on this report, for their unfailingly bipartisan approach. It is always a pleasure working together.

Terry Rumble

Terry Rumble MP
Chairman

EXECUTIVE SUMMARY

It has cost the State an estimated $100m to implement accrual accounting. The benefits have been substantial: better information on assets, liabilities, revenues and expenditures; the revealing of costs that had previously been hidden; and the making of sounder decisions on resource allocation and use.

However, mistakes have been made. Perhaps the biggest was to launch into such a significant change without first undertaking what is normally considered the initial step — an analysis of the various options for implementation, followed by a strategic plan for introducing the selected option, with full costs.

The absence of a budget meant that costs could not be measured against a yardstick and reduced when and where necessary. Therefore, it is likely that eventual costs could have been lower than they were.

As well, actual costs for the adoption of accrual accounting were not separated out in agencies accounts, with the result that the true cost of the exercise will never be known. It is ironic that the very reason for adopting accrual accounting is to disclose a truer cost of service, yet the true cost of adopting accrual accounting itself is unknown.

Further, agencies continue to maintain both their previous cash-based systems and their new accrual accounting systems. Partly this is because the Commonwealth, and the NSW Treasury, still require cash-based information.

Mistakes are always made by pioneers. Despite these, the Committee believes that NSW can be proud of its achievement as the first jurisdiction in Australia to offer to Parliament and the public a truer reflection of reality in the accounts of the State than has ever been available before.

MAIN FINDINGS AND RECOMMENDATIONS

FINDINGS

The problems experienced by agencies do in part, relate back to the issue of insufficient planning and development work being done initially, at the introduction of accrual accounting, in linking the various aspects of accrual accounting back to the budgeting process. Had due consideration been given at the time to working through these links, exploring and defining the problems likely to occur, and developing options and solutions, the application of accrual accounting practices would probably be more efficient and effective than they appear to have been at present from the Committee's own survey and the various submissions and evidence of witnesses to the Committee's inquiry. The Committee considers it a very real possibility that the process of implementation, while successful, has been successful only to a certain point, and would have been more successful and efficient, and indeed more economic, had better planning been undertaken up front and before all else. p. 30

Up until now, the focus has been on ensuring that agency management use accrual information for decision making and for managing resources. This has been successful to the point where agencies have a better understanding of the type of information that accrual accounting can provide for decision making. However, the Committee strongly believes that further benefits are being denied because of the insufficient connections between the parliamentary budget process and the information which is available under accrual accounting. p. 31

It has been generally acknowledged that of all the government jurisdictions both worldwide and within Australia, which have been in the process of implementing accrual accounting over the last ten to fifteen years, New Zealand and NSW are equal leaders at this point in time, having successfully produced audited consolidated financial for the "whole of government". For NSW, this is a significant achievement in the general context of government reforms taking place globally. p. 42

The Committee's terms of reference for the inquiry into accrual accounting did not extend to a full and detailed review of current parliamentary appropriation practices, nor to a review of problems and possible options for future change. However, the implications of accrual accounting for the budget process cannot be overlooked as it is a part of embracing a fuller implementation of the accruals concept of accounting. p. 53

Essentially, there are four major issues which have arisen from the process, and which to date, have yet to be satisfactorily resolved. They are: p. 54

- asset valuation;
- acceptance of responsibility for capital costs and capital charges;
- inadequate professional standards for particular public sector issues such as asset valuation; and
- linking accrual accounting to the parliamentary budget and appropriation process.

The Committee's survey identified costs attributable to the implementation of accrual accounting in agencies as $52.19 million. However, the Committee concludes that a final dollar figure for costs attributable to accrual accounting is unlikely ever to be reached as agency records in this respect are unreliable. The Committee estimates that the cost is likely to be in the vicinity of $100 million. p. 59

For some agencies, the process of implementation has been less than effective. Better strategic planning, and the application of project management practices, should have been undertaken at the beginning of the process. This would have prevented or minimised many of the problems and negative feelings of agencies towards accrual accounting. p. 66

Accrual accounting enabled management to shift their focus to operating results and the financial position of the agency, rather than simply looking at the spending of cash against allocated funds. This means that managers at all levels are now more aware of the true financial and operational results of their areas, and therefore are more cognisant of the need to better plan and allocate resources. Decisions on resource requirements are more likely to reflect actual requirements rather than rough estimations, and as a result of the broader understanding of the myriad of financial implications each decision has, there is more focus and attention on achieving a higher level and quality of service. p. 74

The Committee believes that there is sufficient evidence to suggest that agencies continue to maintain separate internal cash information systems - which may or may not integrate with their 'accrual' systems - to satisfy internal reporting requirements to management, to meet Treasury's continuing requests for cash information; to permit supply of Government Finance Statistics to the Australian Bureau of Statistics; and to allow Treasury to monitor agency performance against cash budgets and appropriations.	p. 77
The Committee recognises the need for Treasury to continue with cash reconciliations to monitor performance against cash appropriations, and acknowledges this as the likely legacy of the speed with which NSW has undertaken its implementation of accrual accounting. This has left the Commonwealth and other government and non-government bodies in other jurisdictions in its wake and having to play 'catch-up' accounting.	p. 79

RECOMMENDATIONS

The Committee strongly recommends that Treasury urgently review the budget process in consultation with appropriate professional bodies and agencies, and that it explore the possibility of introducing accrual-based appropriations.	p. 31
The Committee strongly urges the accounting bodies and associated professions to resolve the issues identified in relation to the valuation of those public sector assets to which there is attached a high level of community service obligations and objectives, the nature of which makes them less likely to be able to be valued by more conventional or commercial valuation practices and principles.	p. 50
The professions involved must recognise that the valuation cannot be encompassed by what is essentially private sector accounting standards. There is a serious need to develop, in consultation with all relevant public sector parties, accounting standards which more adequately reflect the unique nature of the public sector and the services it provides to the general community by way of its assets.	p. 50
The Committee strongly recommends that Treasury urgently review the budget process, in consultation with appropriate professional bodies and agencies, and that it explore the possibility of introducing accrual budgeting appropriations at the NSW Parliamentary level.	p. 54

While the external reporting of accrual information by agencies appears to have risen since initial implementation, it is considered that the internal use of such information would be significantly higher if: p. 80

- external Parliamentary budgets and appropriations were made under the accrual concept of accounting; and
- the end product of the whole process - the consolidated whole-of-government financial statements, together with the audit opinion on those statements from the Auditor-General, were tabled in Parliament.

That Treasury pursue the development of general competency standards for accounting and finance positions within the public sector. p. 86

That accounting bodies and associated accounting standard setters raise the profile of two main issues in their work programs: private/public provision of infrastructure and the valuation of public sector assets. These bodies, such as Australian Accounting Research Foundation (AARF), should work in consultation with Treasuries and Auditors-General in ensuring appropriate and consistent standards are developed and implemented as soon as possible. The Committee considers this considerably overdue. p. 91

That NSW Treasury ensure that, where possible, accounting policy and guidelines on accounting issues adhere to the requirements of the Australian Accounting Standards as promulgated and issued by AARF. p. 94

That where it is evident that an accounting standard does not apply in part or in total to the public sector, that the NSW Treasury consult with the relevant accounting standard setting bodies, the Audit Office and relevant agencies, before issuing policy or guidelines for use. p. 94

CHAPTER ONE

INTRODUCTION

1.1 Background

The implementation of accrual accounting in the NSW budget sector originated in a series of inquiries and reports dating back to the 1970s and 1980s. These reports reviewed in detail the accounting practices and customs prevailing at the time, and recommended a number of changes.

For example, one report which underlied an inherent deficiency in the cash-based method of cash accounting was the 1980-81 NSW Auditor-General's report. This report raised the issue of the land exchanges which occurred between the Commonwealth and the State:

> *As at 30 June 1981, the value of land transferred by the Commonwealth to the State exceeded the value of State transfers to the Commonwealth by some $5 million.*[1]

The cash accounting in force at the time did not require this transaction to be reported even though the State's land assets had undergone a notable change.

In much the same way, the total liabilities incurred by statutory authorities of the State were not disclosed. In the same report the Auditor-General noted:

> *The total outstanding on direct borrowings by state authorities has not been assessed.....*[2]

Later, in 1988, the Public Accounts Committee hosted a seminar in Parliament House to discuss the merits of accrual accounting.

1988 was also a year that saw a change of government in NSW. The incoming government established a Commission of Audit to review the State's finances. The report by the Commission defined accrual accounting:

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1 Auditor-General's Report to Parliament 1980-81 p. 21.

2 ibid. p. 21.

Accrual accounting is the recognition of items as they are earned or incurred (and not as money is received or paid) and included in the financial statements in the year to which they relate.[3]

Also in 1988, the Certified Practising Accountants (CPA's) organised a series of seminars on the need for change in public sector financial reporting. At one of these conferences, Mr Mort Egol of the New York office of Arthur Anderson discussed the relevance of accrual accounting in recognising government debts:

Accrual accounting is a method which forces governments to tax as they spend. This means they are accountable at the time for the taxing consequences of the benefits they wish to confer on the public[4].

At approximately the same time, New Zealand was also exploring the possibility of adopting accrual accounting.

In 1993 the Australasian Council of Public Accounts Committees held a conference in Hobart. At the conference, Mr Peter Williams of the Tasmanian Department of Treasury and Finance, said:

...accrual-based information is important for external assessment of a department's performance and position but it is also important for management information purposes. Management cannot effectively manage assets without identification and valuation of those assets...[5]

The NSW Public Accounts Committee has always maintained a strong interest in accrual accounting, and has seen its implementation as a necessary part of the reform process in public sector financial management. At the 1988 PAC seminar held at Parliament House, the then Chairman of the PAC, Mr John Murray MP, supported the introduction of accrual accounting with the following words:

...I believe an accounting system as a source of information needs not only to account for the spending of the public dollar at year's end, but also it should bring to account, in dollar terms, future obligations.[6]

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3 NSW Commission of Audit 1988 *Focus on Reform Report on the State's Finances* 1988 p. 103. See Chapter 2.2 for a fuller account on the NSW Commission of Audit.

4 Mr Mort Egol, quoted in *Budget deficits: the Hidden Billions,* Australian Accountant, February 1988, p . 44.

5 Mr Peter Williams, *Accrual accounting - How far?* Biennial Conference of Public Accounts Committees, Hobart 1993, p. 125.

6 Mr John Murray MP, *Opening Address* at the Accrual Accounting Seminar, Sydney, 5 February 1988.

The then Auditor General, Ken Robson, speaking at the same seminar, advocated the introduction of accrual accounting to budget sector departments and the preparation of consolidated financial statements for the public sector. Mr Robson claimed that accrual accounting yielded the following benefits:

- the true annual cost of services and an accurate picture of the size of an organisation (or government if a consolidated statement is prepared);
- an annual surplus/deficit that reflects the result of bringing to account all items as they are either earned or consumed;
- the full extent of [an entity's] financial position, that is, its assets and liabilities; and
- meaningful figures for analysis of trends.

Mr Robson pointed out the deficiencies of reporting on pure cash accounting and, to some extent, on modified accrual accounting. These include:

- misallocation of resources (based on incomplete information available to decision makers);
- inadequate disclosure of the size of assets and liabilities;
- clouding of the full cost of programs and cost fluctuations in program costs from year to year;
- imposition of burdens on future taxpayers, by deferring the bringing to account of liabilities such as long service leave and employers' deferred superannuation contributions; and
- imposition of burdens on current taxpayers – that is, by charging in full, each year the cost of assets purchased, rather than by capitalising such expenditures and spreading their costs over their useful life.

By 1993, there was widespread acknowledgement of the advantages for government in moving towards the introduction of accrual accounting. The Organisation for Economic Co-operation and Development (OECD) in a study of worldwide developments in public sector financial management had this to say about cash accounting:

> *While its advantages are acknowledged in terms of assessing (short term) economic impact and compliance with spending limits, its ability to inform decisions on stewardship and the state of*

finances is constrained to considerations related to cash resources and exclude physical and financial assets and liabilities[7].

1.2 Terms of Reference

It is against this background that the Committee received a reference from the then Treasurer of NSW, Mr Peter Collins, to review the introduction of accrual accounting in the NSW public sector. The terms of reference are set out below:

TERMS OF REFERENCE
Under Section 57(1)(d) of the Public Finance and Audit Act 1983

1. To examine whether the implementation of accrual accounting in the NSW Budget Sector has been carried out effectively.

2. To review the adequacy of computerised financial management systems introduced by agencies for the purposes of accrual accounting, and whether such systems integrate into a total management system, linking accounts, budgeting, planning and review.

3. To identify the extent to which Senior Executives of agencies are using accrual information for management purposes, including the costing and monitoring of outputs and inputs.

4. To identify whether sufficient training has been provided to both financial and non-financial staff, and to establish whether financial managers in agencies possess the appropriate level of skills and competencies to provide financial advice and support to senior management.

5. To identify whether agencies have established adequate asset registers which form the basis for Total Asset Management plans.

[7] OECD, *Accounting for what?: The value of accrual accounting to the Public Sector* Paris 1993 p. 10.

CHAPTER TWO

ACCRUAL ACCOUNTING - AN OVERVIEW

2.1 An introduction

The Westminster system of government requires Parliament to control the collection and use of taxes and other charges imposed on the community. There are two ways this control is applied to government agencies. The first is that Parliament controls the direct allocation of monies from the pool of public funds to government agencies. The second is that government agencies must report to Parliament on how they have used the funds Parliament has allocated to them.

2.1.2 Non-Budget and Budget Classification

2.1.2.1 Non-Budget Sector

Some public sector agencies have a substantial amount of independence from the first aspect of Parliamentary control, that is, their nature and activities ensure they do not have to rely heavily on allocations from the Parliament in order to provide public services. They are often known as 'Non-Budget Sector' or 'Outer Budget Sector' agencies, meaning that they do not rely on direct funding from the Public Account. In general terms, they are known also as 'statutory authorities' or 'government trading enterprises' (GTEs).

For these types of agencies, accrual accounting has been in place for a long time. It enables them to establish accountability for resource use, and also to assess and measure performance and financial position in commercial terms. These agencies have been producing operating statements, balance sheets and cash flow statements for a number of years, showing assets and liabilities, and providing information on solvency and capital value. They have been able to use this information to establish the true cost of their services, which then allows user-pays charges and prices to be set accordingly. This enables them to generate funds to improve or purchase other assets, and to undertake large capital works programs.

2.1.2.2 Budget Sector

Other agencies, such as the conventional administration departments, do not generate funds themselves, and must rely on direct allocations from the public purse in order to maintain particular public services. These 'Budget Sector' agencies' transactions are a large part of what is known as the 'Public Account', which is the government ledger, cash book and bank account. Health, public works, roads and traffic, police, fire and emergency services are some traditional 'budget-sector' departments.

Historically there has been less pressure for accrual accounting in these types of agencies. Because their services are not traditionally 'sold' in a market place, there is no commercial measure of success or failure (e.g., there are no profits at the end of the financial period) and performance has largely been measured by the agency's ability to control cash spending in line with the appropriation limit (i.e. the allocation of public money) set by Parliament.

As government financial efficiency was judged on the extent to which annual budget estimates of cash income and cash expenses were met, that is, how much cash came in and how much was spent, budget sector agencies adopted 'cash accounting' because it was the most simple and easy method of accounting. It also adequately met the information needs of Parliament.

The change to a more private sector approach to accounting for the activities of government is a trend occurring both nationally in Australia, and internationally in other jurisdictions. It is recognised now that accountability (which assumes that one party allocates responsibilities and another party takes on those responsibilities) goes beyond complying with legislated limits on spending. Accountability now includes being accountable for outputs and being efficient and effective in providing services. In summary, there is a longer term view on the obligations and financial 'health' of departments which consume large portions of public money and resources. As these resources continue to diminish, or the government's reasons for increasing rates and taxes on the community at large become questioned, the allocation and use of government resources become critical indicators of performance. Since government departments have traditionally been large consumers of resources (particularly taxpayer funds), they are more likely to attract scrutiny, criticism and demands for more information from those who fund their activities.

The change by budget sector agencies from purely traditional cash accounting and reporting to the more private sector approach of accrual accounting is one response to this increasing public information pressure. Accrual accounting means there is more information produced than there was before, which can be reported to the community so that a better picture of the State's financial health can be seen.

2.2 Accrual Accounting - the catalyst in NSW

In the 1980s, governments in Australia and around the world were under pressure to reform the way in which they managed and accounted for their activities, particularly their finances. The public started demanding more information on how governments spent public funds and what governments actually owned and owed. The traditional balancing of cash in a bank account was no longer considered an adequate method of reporting financial performance.

2.2.1 The 1988 NSW Commission of Audit (the Curran Report)

This Commission was a major catalyst for the introduction of accrual accounting in the NSW public sector, particularly for the budget sector.

On 4 April 1988, the then Premier of NSW, the Hon. Nick Greiner, announced the establishment of an independent Commission of Audit to review the State's balance sheet and financial commitments. The Commission was chaired by Mr Charles Curran AO, and the report of the Commission is referred to as the Curran Report. One of the Terms of Reference of the Commission was:

> *To advise on the impact of, and procedures involved in, applying full accrual accounting to all public sector bodies.*[8]

In summary, the Curran Report details how the Commission found that the State had been living beyond its means, and that the high level of State debt and the decline in Australia's competitiveness required that both the private and public sectors operate at maximum efficiency and cost effectiveness. The overspending of previous decades was to give way to future fiscal restraint. The Commission advocated a fundamental change in Government attitudes, and included among its suggestions for change was the adoption of a system of comprehensive disclosure to the community of the financial affairs of the State, and an increased emphasis on balance sheet management.

In Part II of the Report, *"What do We do in the Future?"*, the Commission lists a number of imperatives for action. In relation to the Budget Sector, the Commission believed the State's financial position would be vastly improved by:

- *the preparation of an annual balance sheet and income and expenditure statement for the State budget sector and the Statutory Authorities for presentation to Parliament;*

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[8] *Focus on Reform - Report on the State's Finances,* Executive Summary report, July 1988, Preface.

- *the identification of the State deficit and the Consolidated Fund deficit on an accrual basis in accordance with commercial practices;*
- *the identification of the Public Sector Borrowing Requirement (PSBR) in all budget statements;*
- *the presentation of the Consolidated Fund Statement in a form that clearly distinguishes capital expenditure from recurrent expenditure.*

The Commission recognised the need for improved public disclosure:

> *Accrual accounting, which is seen as a key means of enabling the community to be informed fully on the true condition of the State's finances, is the recognition of items as they are earned or incurred (and not as money is received or paid) and included in the financial statements in the year to which they relate.*
>
> *The Government should adopt a staged implementation for the introduction of accrual accounting in the State budget sector. This will include the bringing to account of unprovided-for liabilities and depreciation . . .*
>
> *. . . The reform of Government financial disclosure is critical to ensure that the community fully understands the financial condition of the State and is, therefore, in a position to provide the broad support required for change.*
>
> *A reformed financial reporting system will ensure that in the future the community will be informed of the Government's financial position, in the (current) environment, thus enabling it to judge more effectively the performance of Government.*[9]

The Report indicated that the Commission recognised the importance of the application of accrual accounting, particularly as it related to the budget sector:

> *The accounting practice in the State budget sector as previously mentioned is basically to prepare information on a cash basis.*
>
> *To change to an accrual basis will require improved accounting systems, involving re-design of present management information systems, computer programming, staff training and standards for treating various accounting matters in a consistent manner throughout the budget sector. These standards should be developed by an independent body including representatives from the professional accounting bodies.*
>
> *Certain aspects of accrual accounting could be introduced in the 1989-90 financial year. These include the accrual of superannuation, long service leave and depreciation.*
>
> *The Commission is of the view that the budget for the State budget sector should gradually be converted to presentation on an accrual basis. It believes it would be confusing to adopt the*

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[9] ibid. p. 51, p. 64.

approach applying in many of the American States where the budget is prepared on a cash basis and accounting and reporting of the budget outcome is on an accrual basis.[10]

With this objective, the Commission outlined a plan for the introduction of accrual accounting in the budget sector:

The Government should adopt the following approach to the introduction of accrual accounting:

- *implement over three to five years - commencing in 1990/91 with most accruals in place within five years;*
- *select five small Departments for initial introduction and through the Parliamentary appropriation, allocate funds to the selected Departments on an accruals basis;*
- *target to achieve appropriation of funds to all organisations on an accrual basis by 1993-94.*

To avoid confusion with a mixture of cash and accrual accounting, the Consolidated Fund should continue to be based on cash accounting until all Departments have been converted to accrual accounting. For the selected Departments, their operations should be handled on an accrual basis through a working account within Special Deposits Account.

The Government should include in the State budget an expense allocation to cover the total accrued costs for these selected Departments. In addition, the Government should include income items for these Departments in the State budget. This will permit the budget to be prepared on a cash basis and for the result to incorporate "accruals" for the selected Departments.

Although some efforts had been made in 1983 with respect to introducing accrual accounting for statutory authorities, and the *Public Finance and Audit Act* 1983 had been amended to this effect, the recommendations from the Curran Report provided a further impetus for financial reforms in NSW. A 'potted' history of events surrounding the introduction of accrual accounting in the NSW public sector is illustrated by the following diagram:

[10] ibid. pp. 103-4.

1983

- Public Finance & Audit Act amended
- Accrual Accounting mandatory for all statutory authorities

1988

- General widespread support for changes to Budget sector agency financial reporting
- NSW PAC holds seminar to discuss issues of implementation of accrual accounting
- Annual report of Auditor-General calls for accrual accounting practices to be expanded to include Budget Sector
- Premier announces in Parliament that accrual accounting will be introduced in first term of office
- Commission of Audit reports that accrual accounting be adopted by Budget sector agencies; implementation to be effected in stages

1989

- Premier formally announces Govt's decision to introduce accrual accounting to the Budget sector over 5 year period
- 70 Budget sector agencies become involved

1990

- Treasury shortens 5 year period to 4 years
- Budget sector agencies to report on accrual basis by July 1992

1992

- Amendments to Public Sector Finance & Audit Act requires departments to prepare financial statements on accrual accounting basis

1994

- By 30 June, whole of Budget Sector on full accrual accounting and budgeting

2.3 Accrual Accounting Explained

2.3.1 Traditional Cash Accounting

Cash accounting is generally considered the most simple form of accounting to understand and the easiest to operate. This is because the identification and recording of transactions is restricted to cash flowing into or out of the organisation. The recording of other transactions (e.g. credit) is delayed until cash payment or cash receipt actually takes place.

The cash accounting basis is used primarily in small businesses where there are only small investments in buildings and equipment, where there is no need to maintain large quantities of inventories and where cash is collected from clients soon after services are rendered. The most common example of cash accounting is where it is used by an individual or family to calculate personal or family cash budgets and reconcile chequebook accounts.

Although the cash accounting basis does not provide users with all the information on the activities of an organisation, it does perform an important function in providing information about an organisation's liquidity or cash flow position. This can help to explain why an organisation which may be generating increasing profits suddenly collapses, or why one which is generating a loss can pay a dividend to shareholders. However, under the cash accounting basis, the only report on operating performance that can be produced is the cash flow statement.

2.3.2 Accrual Accounting

Organisations carry out numerous activities and are involved in various transactions. These transactions result in the organisation both buying and selling goods and services. The action of buying and selling is not always in cash terms. Accrual accounting recognises:

(a) all amounts earned from transactions, regardless of whether they have been collected (revenues);

(b) all goods or services consumed in transactions, regardless of whether they have been paid for (expenses);

(c) all resources controlled as the result of past events and transactions (assets); and

(d) obligations or losses of resources as the result of past events and transactions (liabilities).

For these reasons, accrual accounting is more dependent on the application of two cornerstones to the accounting process; the 'accounting period' convention, and the 'matching principle'.

The first of these, the 'accounting period' convention, breaks up the continuous income-generating activities of an organisation into smaller timeframes to allow users of information to measure more regularly the performance of the organisation. According to the 'matching principle', once the time periods are established, cash payments, cash receipts and other transactions are allocated into their appropriate periods.

So instead of just recording all cash received and paid in the period, accrual accounting also indicates whether services and resources have been bought (which increase or replace other resources). These transactions, however, do not all belong to just one accounting period. Even though operations may be continuous, in order to know exactly an agency's performance in a single accounting period, it is necessary to look at each event and make sure it is recorded and allocated to the accounting period(s) to which it relates.

Transactions which are started and completed in the period are treated no differently than they would be under the cash method of accounting. Only those transactions which are incomplete need to be carefully examined and a further process of allocation into appropriate accounting periods made. With this latter type of transaction, the process of allocation is called 'balance day adjustment'. These adjustments identify:

- revenue earned but not yet recorded (accrued revenue);
- expenses incurred but not yet recorded (accrued expenses);
- allocation of revenue received in advance and prepaid expenses to appropriate periods;
- depreciation expenses (some resources have a long life and their use diminishes over a number of periods);
- ending inventories and cost of sales; and
- adjustments to accounts receivable (debtors) to allow for doubtful debts (i.e. debts unlikely to be collected).

Under accrual accounting, three financial statements are produced (as opposed to only one under the cash base):

- An **Income and Expenditure Statement** (net inflows of assets minus net outflows of assets to show net profit);

- A **Statement of Financial Position** *(or balance sheet)* which would disclose the assets *(future economic benefits controlled by the organisation as a result of past transactions or other past events),* liabilities *(debts or obligations)* and equity *(the difference between the assets and liabilities)* as at the end of the reporting period;

- A **Cash Flow Statement** which is similar in nature to the cash accounting 'receipts and payments statement'.

2.4 Conclusions

A good summary of accrual accounting was given by Mr Dominic Staun, General Manager Corporate Services, State Forests, who described accrual accounting in the following manner:

> *Accrual accounting is not as much a single event as a philosophy and a way of thinking. It is knowing that to derive value in a business you need to control revenues and expenditure and assets from which you derive those revenues. To the extent that we now have, for our managers, monthly reporting, it is not cash reporting. It physically represents transactions that take place that month, irrespective of cash, whether revenue earned has been received, whether expenditure has been incurred, and whether we have paid bills or not. In the results of those transactions the profits are evaluated against the assets to see what sort of return they are making. They know they are judged on that performance. It drives the thinking and the philosophy, which is quite at different odds to the traditional public sector approach in which cash came in and was spent, which might have gone on an asset which you did not know about and on which you did not have any value. The actual cost of utilisation and maintenance of that asset was ignored in future decision-making, whereas in truth that is part of the ongoing cost structure.*[11]

In very basic terms and in contrast to cash accounting, the accrual basis of accounting is dependent on two accounting conventions - the accounting period and the matching principle. Accrual accounting takes cash accounting one step further, in fact, cash accounting is really a sub-set of accrual accounting. The accrual method distinguishes cash as only one type of event occurring in an organisation, and recognises that events other than, but including cash, take place. Together all these transactions reflect what the organisation does and how it has performed. Drawing an artificial line to cut off time into

[11] Evidence to Committee, p. 31.

convenient periods for measuring this performance means looking at unfinished transactions at that artificial line, deciding which portions relate to which time period and then recording them accordingly.

This gives users a 'snapshot' of the organisation in a particular period, and a more informative view of its operating performance.

It is generally considered that accrual accounting provides management and users with more, and better quality, information than its cash accounting counterpart. It provides information on the substance of transactions and events. Cash and accrual information are, however, complementary, and both are important for providing information and allowing effective management. The shift to accrual accounting in government is not implying cash information should be ignored completely, but saying that cash information should not be viewed as the only form of information on which to base decisions and strategic plans.

2.5 Accrual vs Cash - at a glance

	Accrual accounting	Cash accounting
Definition	Accrual accounting involves the recognition of revenues and expenses in the periods in which goods and services are provided or consumed, and not as and when cash is paid or received.	Treats all cash receipts from operations as revenues of the periods in which the cash is received.
Main Elements	Revenues, expenses, assets, liabilities, equity.	Receipts, payments, revenues, outlays
Financial Effects	Revenue is recognised at the point where a sale is made (either cash or credit) or a service provided. Expense is considered to be incurred when benefit is received. Cost of consuming long-lived assets included as depreciation expense throughout useful lives of assets - initial acquisition cost not included.	Revenue not recognised until cash received. Expense recognised at time of payment. Initial acquisition cost of asset recognised (as cash payment) but no depreciation, and asset not recorded in accounts.
Financial Statements Produced	Operating (Revenue, Expenses); also known as Income and Expenditure Statement or Profit and Loss Statement. Statement of Financial Position (balance sheet -assets, liabilities, equity). Cash Flow Statement.	Receipts and Payments. Receipts and Payments by program (for government departments).

Accrual vs Cash - at a glance (continued)

	Accrual accounting	**Cash accounting**
Advantages	Not necessary for a cash payment to accompany the recognition of expenses. Expenses recognised when resources are used up in the process of earning revenue. Matching expenses and revenues. Matching requires balance day adjustments. Appropriate matching of revenues and expenses. Good measure of operating performance. Provides a financial framework for managing resources more economically and efficiently. Able to fully cost each transaction through better cost allocation in ledger accounts. Improves internal monitoring procedures. Precondition to a more competitive approach to business.	Simple to understand Relatively easy to operate Less costly than the accrual system Used principally where there is no need to maintain inventories of goods for sale, where there are relatively small investments, and where cash is collected soon after services are rendered (eg personal income/chequebooks; some small business)

2.6 Illustrative example of Accrual vs Cash Accounting – 'Fictional' XYZ Department

XYZ Department commences operations on 1 January, 19XX. The Department provides advisory services to other government agencies and the general public and sells related publications. The Department has $20,000 cash in a Treasury bank account and has borrowed $12,000 for 12 months through an approved borrowing scheme, for which interest is charged at 12% pa. It rents office space and pays $4,000 for 2 months rent in advance. It has taken out insurance on its state of the art computer equipment and the premium for 12 months is $2,400 payable on 30 January. During January, the Department purchases stock costing $40,000 of which $26,000 is paid for in cash and $14,000 on credit. Sales of the Department's publications during January total $50,000 of which $34,000 is received as cash, and $16,000 is on credit. The cost of producing the publications in January was $32,000 and salaries expenses totalled $10,000.

Under cash accounting

XYZ Department - Receipts and Payments Statement for January 19XX

	$	$
Cash receipts from sales of publications		34 000
Less cash expenditures:		
Stock	26 000	
Salaries	10 000	
Rent	4 000	
Insurance	2 400	42 400
Excess cash receipts over cash expenditure		(8 400)

Under accrual accounting

XYZ Department - Income Statement for January 19XX

	$	$
Sales revenue		**50 000**
Less Expenses:		
Cost of goods sold	**32 000**	
Salaries expense	10 000	
Rent expense	**2 000**	
Insurance expense	**200**	
Interest expense	**120**	44 320
Net Income		**5 680**

The example of a fictional department, XYZ Department, contrasts the accrual basis with the cash basis and indicates, through highlighting the differences between the two, the recognition of revenue and expenditure.

Of particular interest are the following points:

(a) In **cash accounting**, the insurance premium of $4,000 covers two months. However, the statement has brought in the full amount because it was paid in cash (*Problem*: half of this amount actually relates to the next period and should be allocated against the revenues generated in that period).

(b) The cash basis also unnecessarily postpones the time when revenue is recognised. **Cash accounting** does not indicate the $16,000 of credit sales made in January - these will not be recorded until the cash arrives from the customers, even though the sales were made in January.

(c) Both (a) and (b) are illustrative of how measuring operating performance using cash accounting is made difficult, as activities in one period get mixed with activities in others.

(d) A balance sheet prepared under **accrual accounting** will recognise the items 'inventories' and 'cash at bank' as assets. Under cash accounting they are ignored.

(e) Under **cash accounting** expenditure on capital items is treated as an outlay and the whole amount is expensed. Under **accrual accounting**, the cost would be capitalised (as a non-current asset) to be apportioned over the life of the asset (i.e. depreciation).

(f) Sales revenue in **accrual accounting** includes all revenue - cash and credit sales; **cash accounting** includes only cash sales.

(g) The "cost of goods sold" figure in **accrual accounting** (opening stock plus purchases minus closing stock) recognises not only the cash outlay for stock, but also other costs involved in producing the publications.

(h) The rent expense has been apportioned in **accrual accounting** ($2,000 for January and the balance to be brought into the books in the next month).

(i) Insurance and interest expenses in **accrual accounting** recognise that both are costs which should be apportioned over the life of the premium and the loan respectively.

The cash accounting basis does not recognise the interest on the loan as an expense because no cash has been paid out. The net result for January is significantly different between the two bases of accounting. Apportioning the expenses, thereby matching them to the appropriate periods, recognises that there are future benefits accruing to the department, and that as each month goes past, these benefits diminish and become costs against earning each subsequent period's revenue.

2.7 Implications of accrual accounting on the budget process

Traditionally, financial statements used by governments to report operations have been budget-based and have reflected parliamentary appropriations and demonstrated stewardship. It is generally believed that this has lead to limitations on the scope and value of the Public Accounts. The scope of the Committee's inquiry into the implementation of accrual accounting does not allow a full and detailed examination and review of the current budget process. However the Committee considers it important to review the implications of accrual accounting on the budget process in order to present a more complete picture of the effects of accrual accounting.

2.7.1 Traditional Budget Documents

The budget documents for the State contain estimated receipts and payments for the budget period, together with actual receipts and payments for the preceding year. These are generally thought to be the most important financial reports of Government. They cover the major Budget sector transactions and transfers (e.g. grants,subsidies) between levels of government.

The budget is prepared on a cash basis and classifies activities on a program budgeting or functional format. The key outcome or 'bottom line' of the Budget Statement is the *Net Financing Requirement* for the forthcoming period. This is the amount of additional funds required (net borrowings) or excess payments (net borrowings repaid).

The budget documents are multi-purpose, serving legal, economic, social and political purposes. They remain as the key economic statement for overall government accountability, and give details of appropriations, funds and targets for revenue and expenditure. They establish relationships between levels of government and between public and private sector, as well as between government and individual stakeholders. Most of the economic decision making is based on budget estimates and macro-economic policy is administered in terms of progress against estimates.

The cash-based Budget is dedicated to accountability, rather than performance. This is because targets of economic performance are structured around the ability to meet budget estimates, and whether the government needs to borrow more money or repay debt. This means that the financial target is only to get actual receipts and expenditures as close to the estimates in the Budget as possible. Capital expenditure is treated as an outlay in the period, so there is no recognition of the store of economic value where the benefit will be received at some point in the future (i.e. an asset is owned), nor where obligations are being incurred in the present which have an impact in the future (i.e. liabilities are being built up). There is no ability to judge the net worth of the government - i.e. the difference between what it owns and what it owes - so there is no way of reviewing the financial performance of the government over a period of time.

In addition, State Budgets, because they are essentially a 'cash-flow' budget i.e. they look only at cash that could be coming in in the next year, and the cash that could be expected to be going out in the same time period, can be influenced by governments, particularly when elections are close. This is because they have a very short term outlook, and can be manipulated to show particular persuasions in community sensitive areas - such as health spending and policing.

2.7.2 Program Budgeting

Associated with the overall budgeting cycle is the idea of 'program budgeting'. Since 1986-87, program budgeting has been fully implemented in NSW. This process divides the activities of agencies into 'programs' of activities, against which revenues and expenditures are allocated in an effort to show the true cost of the particular program. This aids in decision making by allowing Government to decide which programs and activities are to be undertaken, and how much funding they should receive. It is a further step from just looking at a cash flow type of budget because it allows recurrent services and capital works to be appropriated separately but detailed together - ie. it shows the overall funding required.

The very nature of programs indicates a continuity of activity. Activities within a program do not stop at a particular point in time, but go on over a number of time periods until they are no longer required or judged worthy of funding. However, under program budgeting, there is still the requirement to determine the cost of a program at a particular point in time, which means the picture is still incomplete. It does not take into account that the agency could have made commitments in the future to ensure the continuing achievement of the program's objectives. Also, as it is only an annual budget arrangement, any change in policy by government and the implications this has on the true and overall cost for the program is not shown.

2.7.3 Agency Issues and Implications Arising

There are several issues which have arisen at the agency level from changing to accrual accounting and reporting without any major concurrent change to many aspects of the Budget process.

2.7.3.1 Reconciling Accrual Information to Cash Budgets

In Chapter Five of this Report, the implementation of accrual accounting in NSW is reviewed. For many agencies, the recurring problem is the need to continue to maintain some form of dual accounting system. This provides cash information to serve Treasury's needs for reconciliation back to cash appropriations and budgets. This continuing focus on cash information is acting to the detriment of a greater internal use by agencies of accrual information.

Much of the problem lies with the need to reconcile performance back to a cash budget. As previously noted, the Curran Report acknowledged that as part of the introduction of accrual accounting, there was a need to introduce accruals based budgeting. This was to prevent the current problems that have been expressed by agencies, that is, the general confusion in mixing cash and accruals information, and enhance the overall usage of accruals information for decision making, both by agencies and by Parliament.

It is technically possible for a budget based on accrual principles to be prepared and for an authority's expenditure to be reported on an accrual basis. After all, in the private sector, it is the accepted method of planning for future income and expenditures, and making decisions on where available resources can be put to the best use. Accruals budgeting allows the organisation to:

- monitor trends in receipts versus revenue;
- recognise that a number of expenditures which occur infrequently may not relate to the period in which the expenditure is made;
- identify the extent to which some expenditures have been deferred; and
- recognise asset depletion through amortisation and depreciation.

An argument against cash budgeting was expressed by Mr Tony Harris, Auditor-General NSW:

> *I think you can say that the accrual accounting, even at a departmental level, but certainly as it gets aggregated, provides useful information for people. But I think Treasury's belief in cash is misplaced and wrong; that is the view that the cash budget is a good indicator or a better indicator of macro-economic effects is wrong. Cash is so easy to manipulate. It does not look like it . It looks like cash would be the hardest thing to manipulate, but a cash-based budget is so easy to manipulate, that to have faith in it is to have misplaced faith. Thus it drives you down inevitably towards an accrual-based budgeting system. But I am not quite sure how Parliament fits into an accrual-based budgeting system.*[12]

The Committee agrees with the thrust of the above comments, and through analysis of its own survey responses, acknowledges that the continuing reconciliation process

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12 ibid. p. 77.

from accrual information back to cash, for agencies, is deterring a greater success in the overall implementation of accrual accounting.

2.7.3.2 Continuing focus on short-term results

Apart from the need to supply cash information to Treasury so that Treasury can monitor economic targets against the cash-based Budget and appropriations, agencies have identified a number of other problems. The Committee believes these are indicative of the problems associated with not having a fully implemented accrual budgeting and appropriation system in place.

The first example from Mr Ken Barker, Director of Finance, Department of Health, supports the view that cash-based budgeting focuses on the short term outcomes:

> *We must have a cash system of information for Treasury because that is its key performance indicator, how we go on a cash basis rather than how we go on an accrual basis. As Treasury focuses on cash, it is very much a 12 month cycle, so where you are on 30 June is how you perform. Treasury does not have a longer term view of how you are performing.*[13]

2.7.3.3 Disclosure in Statements of Non-Budget Amounts/'Special' Items/Off-Budget Items

An example from Mr Barker indicates that there are problems in classifying cash and other capital items which may not have previously been disclosed:

> *Because it is so focussed on cash, the other problem we have in health is that our accounts reflect not only what Government gives but also special purpose and trust funds, which include bequests of money, funds raised, doctors' trust funds and all those sorts of things. At times our Treasury colleagues see the amount of cash on the balance sheet and think that that is all government money. That causes some internal discussions with them.*[14] . . .
>
> *... Hospitals often have fund raising days and fetes. The local Lions Club might donate stuff to them. People die and leave something in their wills to them. Under certain arrangements, doctors who work in hospitals can generate private income and then a percentage of that goes back into the hospitals. You can charge for car parking and a whole range of things. We were capturing some of those, but we were not capturing the whole lot.*
>
> *So when you look to the cost of health, you never really knew what the real cost was. Things would mysteriously appear in the capital works area; it was not here one day and it was here the next, but it never went through the formal capital program. We then had to work out a process*

13 ibid. p. 41.

14 ibid. p. 41.

and we set up a policy on how to capture this information and we are capturing it all. That has had a substantial impact upon what we are saying we are spending compared with what we were spending a number of years ago. It has also impacted our capital works program in terms of the size of the capital program.

That was a major reform we had to implement, as well as doing the normal accrual accounting. The big dilemma we always faced was that people are always very sceptical of Treasury. They are always saying "Well, as soon as we identify this, Treasury will rip money off us to compensate for what we have now found, which we have always had.[15]

A similar example was related by Mr Ken Dixon, Director of Finance, and Mr Kevin Sykes, Director of Audit, Department of School Education in relation to school-raised income and school bank balances:

Mr Sykes: The only things that are not included [in the department's records in relation to schools] are school-raised income and school bank balances, although those balances, which are the subject of some discussion with the Auditor-General at the moment, are included as a note to the accounts. [The issue] has not been resolved and it is still being discussed by Treasury, the Audit Office and the Department.

Mr Dixon: We mentioned the amount of money held in school bank accounts as a note to our financial statements, but we did not bring cash book balances into our financial statements proper because we do not consolidate school financial data or aggregate it to form part of the financial statements of the department. There is currently an issue between Treasury, the Department and the Auditor-General's office as to whether that should be done and whether it can be done. We would argue that because we identify a level of school bank balances in our financial statements and we bring to account the vast majority of expenses incurred at the school level, particularly salaries - grants paid to schools for global budgets are picked up in our financial statements; the major asset base, particularly buildings and land, is picked up in our financial statements - we cannot account for the vast majority of school financial details in the financial statements. But it is an issue that is yet to be resolved.[16]

2.7.3.4 Capital Costs and Funding Non-Cash Items - Who Should Budget and Account for These?

There is an issue which arises from accrual accounting which revolves around who bears the costs of capital and the newly identified 'non-cash' items such as depreciation and employee entitlements.

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15 Public Accounts Committee, *Proceedings of the Seminar on Accrual Accounting - The Scorecard to Date*, 13 December 1994. Report No. 89, February 1995 p. 41-42.

16 Evidence to Committee p. 50.

There are large amounts of capital and capital assets within government. If the true costs of services are to be disclosed, then ideally the cost of the capital component should show in the financial statements of the agency together with depreciation.

However, at present there appears to be confusion as to who, if anyone, is bearing the costs of this capital. If it is not the departments, then why are they accounting for the non-cash item associated with capital i.e. depreciation?

Mr Ken Barker, Director of Finance, Department of Health:

> *[I]n terms of the process under accrual accounting our people have to reflect expenses and payments as technically they are incurred rather than when they receive the money or pay the account. There is more change in the balance sheet items under assets. People are much more conscious now that if they have land and buildings which do not have a desired use they may be able to do something with them. A number of years ago Treasury allowed any asset sales to have 100 per cent of the proceeds retained by the department. Therefore people are focusing on the balance sheet items to see whether they are surplus and their values under an alternative use, which may result in funds for general infrastructure. One problem we have is that Treasury still funds things such as employer super[annuation] centrally. Therefore, that is still not a cost to us; it is still a cost to government. So we might go ahead and do something involving staff engagement activities without reflecting the cost of employer super[annuation] because we are not responsible for it. They are the sort of things that can cause problems in working up some action.*
>
> *We may want to shift money around within the global allocation but we do not have a clear idea of the full cost. So when we are trying to establish something on a full cost basis we cannot be sure of capturing all those costs. We are certainly trying to use accrual accounting to fully reflect our costs for the things that we do spend our money on, and bringing in a component for capital. That again presents a problem because capital is still very much on a bid-and-review basis with Treasury and how the capital works program is funded. So if we want to bid for capital we will bid for our capital separately, on how we are going to fund it. Therefore, in terms of working out whether it is a good thing to construct and build you do not have to factor in, as someone in a commercial undertaking would, a rate of return on your investment in the capital because there is no capital funding policy in place. We have agreement with Treasury that we will move ahead with that from next fiscal year and have formal capital funding in place from June 1998, but if you do not have a capital funding policy in place you are still effectively matching your capital investments with your operating investments. So there are still some problems in our decision making process.*[17]

Another view on the issue of capital costing from Mr Tony Harris, Auditor-General NSW:

> *Ken Barker introduced another very important issue that I wanted to spend some time with today and that is the cost of capital. Again, in the private sector, the cost of capital will be reflected in the revenue charged, otherwise the firm will go out of business. The shareholders will be most*

17 ibid. p. 33-34.

upset. When you look at agencies in the NSW public sector, that cost of capital issue is not yet properly reflected.

I will give you some examples. Corrective Services, as an agency, had a net cost reported normal of about $280 million last year. The capital it used to provide those services - the cost is not fully embedded in that net cost of services only the depreciation, or the use, or the run down of the capital is there, not the charging for the capital - they in fact have about $800 million worth of net assets. If we use a convenient figure of 10 per cent - in fact the cost of capital to the State is closer to 11 - we would find their net cost of service would have to be increased by about 30 per cent in order to reflect that issue.

I suppose the biggest and most interesting [thing] in looking at this exercise of cost of capital is the Department of Water Resources, which has a net cost of services of about 21 million, but it uses $3 billion worth of assets. If you charge for those assets, the net cost of services obviously would be something like $321 million and there is a very big difference between those two figures.[18]
It amuses me that the Darling Harbour Authority makes a profit each year, or can make a profit - sometimes it makes a small loss, sometimes it makes a small profit - but it amuses me because the person or the agency that is picking up the debt.....is Treasury, so that we have the Darling Harbour getting all of the revenue that it can while Treasury meets the cost of the debt that was used to develop Darling Harbour.

That, I think, gives a wrong picture about society's involvement in Darling Harbour. People look at it and say "wasn't that a good investment", but instead of making $1 million a year, it loses nearly $2 million a week in uncovered interest. When that becomes public, then the society is better placed to say do we really want another Darling Harbour if the cost is $100 million a year *(emphasis added).*[19]

2.7.3.5 Agency Issues in Summary

In his address at the Public Accounts Committee's Seminar on Accrual Accounting - The Scorecard to Date, Mr Ken Barker sums up the main issues which still need to be resolved at agency level:

I think those at Treasury have to change their emphasis to be more accrual focused. I think they have to introduce a capital charging policy and I think they have to have a serious look at how they split their capital/recurrent funding up.

... I also believe they have to fully fund their accrued items and they have to make agencies responsible for those accrued items; by that I mean depreciation, which comes into the capital charging policy, and also the provision for superannuation and employees' leave entitlements.

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[18] Public Accounts Committee , *Proceedings of the Seminar on Accrual Accounting - The Scorecard to Date, 13 December 1994,* Report No. 89, February 1995 p. 55.

[19] ibid. p. 86.

Within Health, unlike a lot of other budget sector agencies, all our public hospital staff do not access the Treasury pool for accrued long service leave - that is internally funded, so that if any of our staff go off on accrued long service leave, they [the hospital] have to finance it themselves. I do not see why Treasury cannot expand that across all of government. In respect of superannuation, I believe it should do the same for the ongoing responsibilities of agencies, not the accrued liabilities, but the ongoing responsibilities.[20]

The Committee concurs with the thrust of these comments.

2.7.4 Possible Solutions

The Committee notes the work done in other jurisdictions to resolve the issue of appropriations on an accruals basis. It notes the current situation in New Zealand, which has been publishing measurement data on outputs for a number of years. It has integrated these measures in the Budget process, with funding being allocated on the basis of negotiated output quantities and price. New Zealand has also moved to contractual budgeting, which is an extension of the output measures requirement. This represents a commitment by a Minister or agency to provide certain outputs or achieve certain outcomes given the level of Budget support, together with a requirement to state whether that commitment was achieved at the end of the period.

There is also good reason to note the recommendations in a recent report by the Comptroller and Auditor-General (National Audit Office), United Kingdom which reviewed a July 1995 White Paper setting out the UK Government's proposals for the introduction of resource accounting (i.e. accrual accounting) and budgeting in central government. In this report, ***resource budgeting*** is defined as:

- *the application of accruals accounting techniques to the planning of public expenditure; and*
- *the Parliamentary voting of resources each year on an accruals basis through the Supply Estimates. The first resource based estimates are to be presented for the year 2001-02.*[21]

As well as detailing the implementation of resource accounting, the report contains a detailed and diagrammatic explanation of how resource budgeting can be introduced. Because the nature of government in the UK is similar to that in Australia (both using the originally English Westminster and bicameral system), there is merit in reviewing the manner in which it is proposed to bring about parliamentary appropriations on an accrual basis. At present in the UK, Parliament votes moneys to departments on a cash

[20] Public Accounts Committee - Proceedings of the Seminar on Accrual Accounting - *The Scorecard to Date,* 13 December 1994. Report No. 89 February 1995, p. 49.

[21] *Resource Accounting and Budgeting in Government: The White Paper Proposals* - Report by the Comptroller and Auditor-General, National Audit Office. HC 334 Session 1995-96, 24 April 1996.

basis, with some departments having more than one cash-based Estimate, each voted separately (Note: this is similar to NSW in that recurrent and capital funding are separate, and appropriations are still voted on a cash basis). The Comptroller and Auditor-General notes that:

> *In the new form of Estimate proposed in the White Paper, Parliament would be invited to vote for each department:*
>
> - *the current resources, on an accruals basis, required for a department's programmes of activity; and*
> - *the total cash needed to finance those programmes.*

The Report details many aspects of resource budgeting, whilst recognising that there are still a number of issues to be detailed and resolved. However, it is interesting to note the comments of the Comptroller and Auditor-General on how a new 'dual' system of parliamentary budgeting and appropriation may work:

> *In my earlier report on the Green Paper I commented that there would be advantages for departments and for Parliament if Parliamentary control and authority were aligned with departments' and governments' own processes for planning, managing and accounting for expenditure: the Supply process should ideally work with the grain of the way in which government manages its finances, and not burden departments with a requirement for additional systems solely for the purpose of financial reporting to Parliament. The proposal for dual voting of cash and resources would seem to meet those criteria. Furthermore, this proposal neatly stiches together government's need and wish to control the cost of programmes in resource or accruals terms with Parliament's historic interest and practice in voting cash.*
>
> *Another issue arising from dual voting of cash and resources is whether accruals or cash control will or should be paramount for example where a department is within its resource budget but needs to breach its voted cash total in order to spend those resources. In principle, the two control bases should not conflict because the voted cash total is derived from current resources and allows for all balance sheet movements, including working capital.*
>
> *In practice, departments will need to monitor and control working capital as well as cash to ensure that they stay within the voted cash amount, and this may require new skills. In these circumstances, Parliament may consider that a breach of either voted figure, cash or resources, represents a failure of financial control which ought to be reported to Parliament and which will require supplementary Parliamentary authority for additional cash or resôurces.*

The Committee recognises that there is still much work to be done in this area. However the developments in both New Zealand and in the United Kingdom are certainly of interest to the Committee. The terms of reference of the Committee's inquiry do not extend to a full and detailed review of the current parliamentary budget process, nor to a review of options for change in this area. However, the Committee acknowledges current developments in appropriations in New Zealand and in the

United Kingdom as being ones which are of interest and whose principles could form the basis for any future change in NSW.

2.7.5 Treasury Progress on Issues

In its detailed submission to the Committee, Treasury indicates it is reviewing the situation and has already made some progress towards tackling the issues of concern expressed by agencies. All of these issues relate back to both internal agency budgeting and the need to move towards accrual budgeting and appropriation on the parliamentary level.

With the benefit of hindsight, it would have been more appropriate to think through the links between accrual accounting and its implications on the budget process prior to commencing the implementation process in 1990-91. This may have minimised or prevented many of the current problems experienced by agencies. Greater forethought may have made possible a budget process that took into account the continuing nature of services, over many periods, rather than a simple cash allocation each year, which must be reviewed and resubmitted every 12 months.

According to Ms Thuy Mellor, Acting Assistant Secretary, NSW Treasury, there are current developments in respect to introducing accruals based budgeting for the NSW public sector:

> *The Public Accounts this year are also subject to financial audit by the Auditor-General. The Treasury also intends to apply the same accrual principles to the budgeting process. However, because of the budgetary computer system we have in Treasury, we cannot do that at present. At the moment we expect it to apply for the 1996/97 Budget year.*[22]

Treasury's detailed submission to the Committee's inquiry also indicates some of the work already done to address the problem:

> *[Previously] the Operating Statement in the annual accounts of agencies differed from that in the Budget Papers. The annual accounts format was fully accrual based and similar to commercial accounting reports. The Budget Papers, on the other hand, were concerned primarily with converting accrual-based information to a bottom line Consolidated Fund allocation position. The Budget Papers did not highlight important accrual-based results, especially the "Net Cost of Services".*
>
> *The Treasury has now redesigned the Budget Papers and annual accounts formats to be in line as much as possible. With hindsight, it would have been better if both cash and accrual-based targets were introduced at the start of the implementation process. This would have ensured CEOs took more seriously accrual accounting, budgeting and reporting from the*

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[22] Public Accounts Committee - *Proceedings of the Seminar on Accrual Accounting - The Scorecard to Date, 13 December 1994,* Report No. 89, February 1995, p. 16.

> *start. Public sector organisations should be no different from their private sector counterparts in controlling their operations through both accrual and cash targets.*
>
> *In order to further encourage CEOs to use accrual-based reports, the Treasury has now designed pro-forma monthly financial reports for internal use by senior managers. These reports incorporate the features of the Budget Papers and the annual accounts formats, especially the focus on Net Cost of Services and Consolidated Fund Appropriations. The view is that senior executives will be more encouraged to use accrual-based financial information if the reports they receive each month contain information in the same format as that published in the Budget Papers and the annual accounts.*

And from Ms Mellor:

> *. . . Treasury recently put out a paper on capital charge for comment by agencies on the capital charge incentive. One thing I have to say is that New Zealand actually introduced that capital charge for the last two years that I know of, if not three, so the Department actually paid the capital charge to the Treasury every six months and the capital charge is nothing to do with new capital investment.*
>
> *We also need to clearly explain the parliamentary control mechanisms under the accrual budgeting regime. We should explain whether parliament controls only cash or whether the parliament also controls the net cost of services, and exactly what is meant by "parliamentary control of the net cost of services.*[23]

The Committee acknowledges this work and notes the initiatives Treasury has indicated are in train at present within Treasury work plans and programs to rectify the problems which includes:

- commencement of publishing output and possibly outcome measures in the Budget papers;
- progress towards establishing frameworks to ensure increased efficiency in the delivery of goods and services;
- development of performance indicators (this links back to the development of output measures) to assess broad performance and to develop benchmarking measures of best practices;
- continual monitoring of the trend towards contractual budgeting issues; and

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23 ibid. p. 87.

- issue of a discussion paper to agencies on measuring and reporting the full cost of capital and disclosing capital charge issues.[24]

2.8 Conclusions

The Committee's terms of reference for the inquiry into accrual accounting do not extend to a full and detailed review of current appropriation practices. Nor do they extend to reviewing problems and possible options for future change. However, the implications of accrual accounting on the budget process cannot be ignored, as it is part of a fuller implementation of the accruals concept of accounting.

At best, the Committee has sought to outline in brief, what it understands the problems to be, and although largely at agency level, the issues can be linked back to problems in the budget process. At present, even though the Budget Papers can reflect accruals concepts, there is still a requirement to balance back to the original Parliamentary cash appropriations estimates at the end of the financial period. The Committee feels that Treasury's work to date, while commendable, has only gone so far in achieving the desired and complete change to accrual budgeting in the NSW public sector.

FINDING

The problems experienced by agencies do in part, relate back to the issue of insufficient planning and development work being done initially, at the introduction of accrual accounting, in linking the various aspects of accrual accounting back to the budgeting process. Had due consideration been given at the time to working through these links, exploring and defining the problems likely to occur, and developing options and solutions, the application of accrual accounting practices would probably be more efficient and effective than they appear to have been at present from the Committee's own survey and the various submissions and evidence of witnesses to the Committee's inquiry.

The Committee considers it a very real possibility that the process of implementation, while successful, has been successful only to a certain point, and would have been more successful and efficient, and indeed more economic, had better planning been undertaken up front and before all else.

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24 Report of Proceedings before the Public Accounts Committee Inquiry into Accrual Accounting, 6 March 1996 - Detailed Submission 30 December 1994 p. 23-29.

The Committee recognises that there is a very real need to 'complete the circle'; that is, to finish off the implementation of accrual accounting as originally envisaged in the recommendations of the Curran Report and the 1988 Commission of Audit.

FINDING

Up until now, the focus has been on ensuring that agency management use accrual information for decision making and for managing resources. This has been successful to the point where agencies have a better understanding of the type of information that accrual accounting can provide for decision making. However, the Committee strongly believes that further benefits are being denied because of the insufficient connections between the parliamentary budget process and the information which is available under accrual accounting.

The Committee believes there is a need for the focus to extend further and for Parliament to begin using the large volumes of accrual information that are being generated to make strategic decisions in respect of the funding of government and community services and programs. Some of the work has already been done. However, if the process of developing and adopting a system of accrual based appropriation is not given greater priority, it is likely that NSW could fall behind other jurisdictions in this area. Instead of leading the way, the State could be following.

RECOMMENDATION

The Committee strongly recommends that Treasury urgently review the budget process in consultation with appropriate professional bodies and agencies, and that it explore the possibility of introducing accrual-based appropriations.

CHAPTER THREE

HOW DO OTHER JURISDICTIONS COMPARE?

3.1 New Zealand

Since 1984, New Zealand has undergone a comprehensive program of economic reform. The New Zealand government introduced accrual accounting as an integral part of a comprehensive system of management reform initiatives.

Since accrual accounting is a necessary prerequisite for measurement of ownership and purchase performance, the first step was to separate commercial activities from those of government departments and form State-Owned Enterprises (SOEs). The *State Sector Act* 1988 and the *Public Finance Act 1989* provided the legislative changes needed. Public Finance Act required accrual based financial statements for the Crown to be produced from 1 July 1991. This required departments to specify their outputs as well as to install new computer software, and to introduce new banking, costing, monitoring and reporting systems. According to the former Minister for Finance, Mr Birch:

> *The adjustment was achieved smoothly and the last department made the change six month ahead of the statutory deadline ... some initial teething problems arose, notably the valuation of assets and the implementation of costing disciplines, but these have largely been overcome.*[25]

In October 1992, the first comprehensive set of accrual-based annual Financial Statements of the Government of New Zealand were tabled in Parliament. The tabling was the culmination of two years work moving the government onto an accrual reporting regime.

The *Financial Responsibility Act* 1994 established a framework for the responsible conduct of fiscal policy and required governments to report to Parliament on their long-term fiscal objectives.

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[25] *Public Accounts: Accrual Accounting in Central Government*, Parliamentarian, April 1995 p. 114.

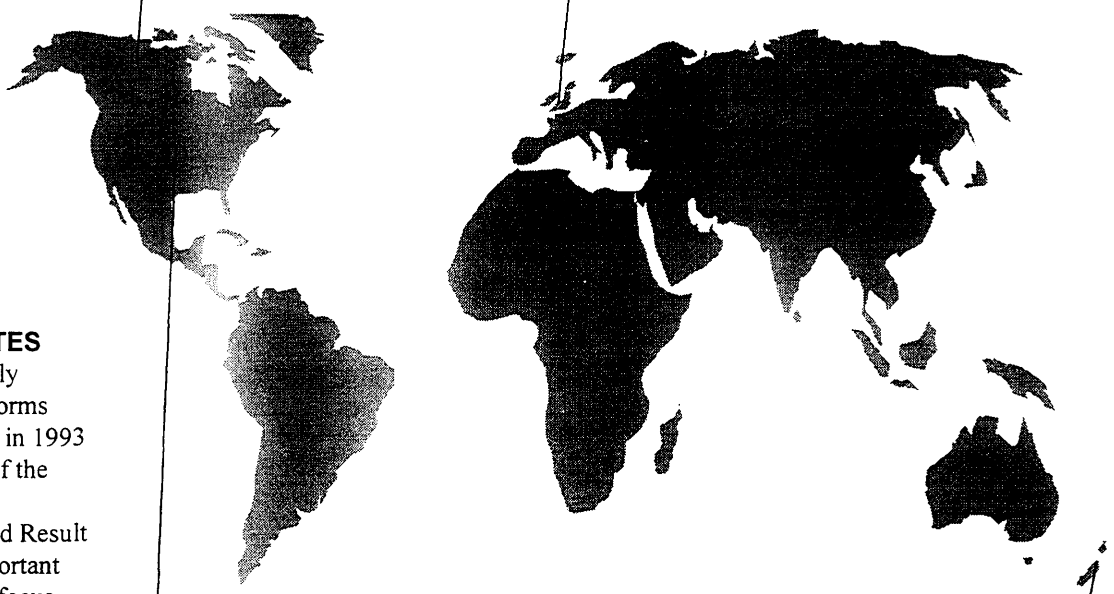
PROGRESS OF ACCRUAL ACCOUNTING IN OTHER JURISDICTIONS AT A GLANCE

CANADA

Has instituted Service Standards Initiative and Public Service 2000 initiative. Focus heavily on employment and personnel, central administrative controls, roles of central agencies, and innovative ways to encourage efficiency and effectiveness

UNITED KINGDOM

Launched Financial Management Initiative in 1982 focussing on value for money in provision of public services. Establishment of executive agencies in 1988 represented major shift in favour of applying accrual accounting within public sector and success has seen accrual accounting extend to government departments. Government White Paper of July 1995, envisages 'resource' (accrual) accounts to be in place in 1998 and 'resource" (accrual) budgeting by 2000.



UNITED STATES

Has been steadily undertaking reforms since 1981, and in 1993 the enactment of the Government Performance and Result Act was an important step in shifting focus away from inputs and adherance to prescribed processes, and towards achieving results. Under the Act, agencies are to implement comprehensive accrual accounting and result-oriented reforms.

NEW ZEALAND

Next to New South Wales, probably the most advanced in the implementation of accrual accounting. Economic reforms, including introduction of accrual accounting and reporting commenced in 1982. Accrual based statements for the Crown to be produced from 1991, and first comprehensive set of accrual based annual Financial Statements of the Government were tabled in Parliament in 1992. Has already established systems to accrual budgeting and for parliamentary appropriations to be made on an accrual basis.

In a 1994 report, entitled "New Zealand's Reformed State Sector", the State Service Commissioner offered a positive view of the reforms, indicating that the much smaller core public service was beginning to show clear improvements in operating efficiency and in responsiveness to clients. He saw the reforms as being extremely successful in providing transparency in the activities and processes of the State and liberating managers from central input control. He also recognised that the new financial management and accounting systems look set to revolutionise the ways in which departments and officials work.[26]

New Zealand has implemented arrangements for comprehensive reporting at the whole of government level and has now developed a true picture of its assets and liabilities.

3.2 United Kingdom

The Financial Management Initiative launched in 1982 marked the start of a general and co-ordinated drive to improve financial management in government departments.

Presently, central government plans its spending on a cash basis. The system does not take full account of the government's resource consumption i.e. the distinction between capital and recurrent spending and the outcomes of that spending. Resource accounting and budgeting will change this.

The Financial Management Initiative focused on the value of money in the provision of public services. Key developments in this extensive programs of reform include:

- improving financial systems in government departments;
- the creation of executive agencies to deliver executive functions;
- clear focus on aims, objectives and measurement of performance; and
- a customer orientation.

The establishment of executive agencies from 1988 represented a major shift in favour of applying accrual accounting within the public sector. Experience of the successful production of accrual accounts by executive agencies has encouraged their extension to core Government departments. Beyond this, they have fostered the broader ambition to extend accrual concepts to the planning process.

The Government's White Paper "*Better Accounting for the Taxpayer's Money: Resource Accounting and Budgeting in Central Government*" was presented to

[26] New Zealand. State Services Commission (1993), *New Zealand Public Sector Reform*, p. 14.

Parliament in July 1995. It is envisaged that departments will produce resource accounts to report and resource budgets to plan expenditure, both on the same accrual accounting basis.

The Paymaster General, David Heathcoat-Amory MP, explained the role these reforms would play in improving management resources in government:

> *The UK public sector, through a wide ranging reform programme, is preparing itself for the challenges of the 21st century. The Government's reforms of the public expenditure system, which do bear parallel with the reforms of the Gladstonian era in their historic significance, will take us forward to a new era well equipped to grasp the opportunities for the better management of resources in the public sector.*[27]

The government's proposal on Resource Accounting and Budgeting contained a commitment to the implementation of "Resource Accounts" to be in place in 1998 and "Resource Budgeting" by the year 2000. The current Appropriation Accounts will be replaced in Parliament by Departmental Resource Budgets, thereby enhancing the information on departmental performance that would be available at the end of 1996. This will enable Parliament, through its Departmental Select Committees, to link resources more closely to aims and objectives of programs, while retaining overall approval for the financing of such resources.

3.3 United States of America

In the United States, New York has so far been the state with the most evident interest in accrual accounting. Even in the late 1970s, New York was exploring alternative ways of presenting its accounts so as to make the true cost of government more obvious. In 1987, the Comptroller of the State of New York spoke at a seminar on accrual accounting held in Sydney. He said about his new accounting proposals:

> *From a technical aspect, it was one of the broadest and most complex accounting conversions ever to take place. But the political process was equally ambitious and difficult. Involved were fundamental changes in state statutes and procedures . . . I was proposing to change a whole style of governance.*[28]

In other words, New York State instituted a central accounting system designed to comply with Generally Accepted Accounting Principles. The State was then in a position to prepare annual financial statements that followed accepted accounting

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27 HM Treasury Press Notice, 18 September 1995.

28 The Hon. Edward v. Regan, Comptroller of the State of New York *Can Accrual Accounting Work in Government* Conference, Sydney 30 November 1987.

format. Within a two year period the State installed a new centralised accounting system and commenced a training program to upgrade the skills of State agency accounting staff.

A major achievement at this time was the ability of the New York State to submit its Annual Financial Report to an independent audit. The audited financial report allowed the public to see for the first time the financial position of the State. The extent and nature of the accumulated deficits and short term borrowings were revealed.

Since then, New York has moved further towards the adoption of a full accrual accounting system.

3.4 Canada

In December 1989, the Canadian Government instituted the Service Standards Initiative and introduced a Public Service 'renewal' initiative called Public Service 2000. It was designed to streamline financial processes and improve organisational culture and performance to 'better serve' Canadians. The initiative was described by the Prime Minister as "the policy of the Government of Canada concerning the measures necessary to safeguard and promote the efficiency and professionalism of the Public Service in order that it may serve Canadians effectively into the 21st century". The initiative focused heavily on the Government's employment and personnel management regime, central administrative controls, the roles of central agencies and systems of personnel, and innovative ways to encourage efficiency and improve programme delivery.

In the February 1995 Budget, the Minister of Finance announced the Government's intention to adopt "full accrual accounting". A major result of this would be that the costs of acquiring capital property would be recorded as assets. These would then be included in expenditures in any one year only to the extent that assets were used in that year (or became obsolete).

A November 1995 analysis by the Treasury Board Secretariat also indicated that a change to accrual accounting, supported by appropriate technology and information management, would provide significantly better cost data. Such a system would also make it easier to compare alternatives and understand the costs of programs.[29]

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[29] Canada, Treasury Board (1995), *Strengthening Government Review.*

3.5 Australia at the federal level

The establishment and subsequent report in 1992 of a joint Federal/State Working Party to consider issues associated with public sector accounting, reporting and budgeting was an important stimulus to change. The Working Party concluded that while cash had traditionally been the basis of government accounting, its extension to include information on assets, liabilities, revenues and expenses would contribute towards better overall resource management. In summary, the Working Party recommended that:

- where information derived from accruals systems would assist in the management of resources, governments pursue the introduction of such systems:

- financial statements that are prepared on an accrual basis should be prepared in accordance with Australian Accounting Standards and Statements of Accounting Concepts.

The decision to require Federal Government departments to move to financial reporting on an accrual basis was announced by the then Minister for Finance, Ralph Willis, on 4 November 1992. The implementation date was set for the year ending 30 June 1995.

The implementation date of 30 June 1995 was set for all Commonwealth departments to report on an accruals basis. Ten departments participated in a pilot program implementing accrual accounting in 1992-93 with a further ten following in 1993-94. All Federal agencies should by now report on an accrual accounting basis. As with NSW, many of these agencies have experienced considerable problems in this process.

The *Financial Management and Accountability Bill* 1994 was intended to provide a legislative framework to enforce accrual accounting and reporting. The legislation, however, has lapsed.

During 1994 the Australian National Audit Office conducted an audit to determine how well equipped the budget sector was to fulfil its financial management and reporting responsibilities. The audit found that many agencies were not well prepared for the introduction of full accrual reporting.

In 1995 the accounting firm Ernst & Young released the results of a national survey of accrual accounting. The survey was set against the issue of Australian Accounting Standards AAS27 (Financial Reporting by Local Governments), and AAS 29 (Financial Reporting by Government Departments) which called for the adoption of accrual reporting at Local, State and Commonwealth government levels. The results of the survey noted that some 30 percent of agencies had not used an implementation program, and over 30 percent of respondents saw no other use for accrual reports than to satisfy a legislative reporting requirement.

The National Commission of Audit, chaired by Professor Bob Officer of the University of Melbourne, was set up after the March 1996 election. In June 1996, the Audit Commission recommended sweeping changes to the Federal Budget and to the way the Commonwealth manages its agencies. In that context, it also recommended greater honesty in public accounts.

The Audit Commission recommended:

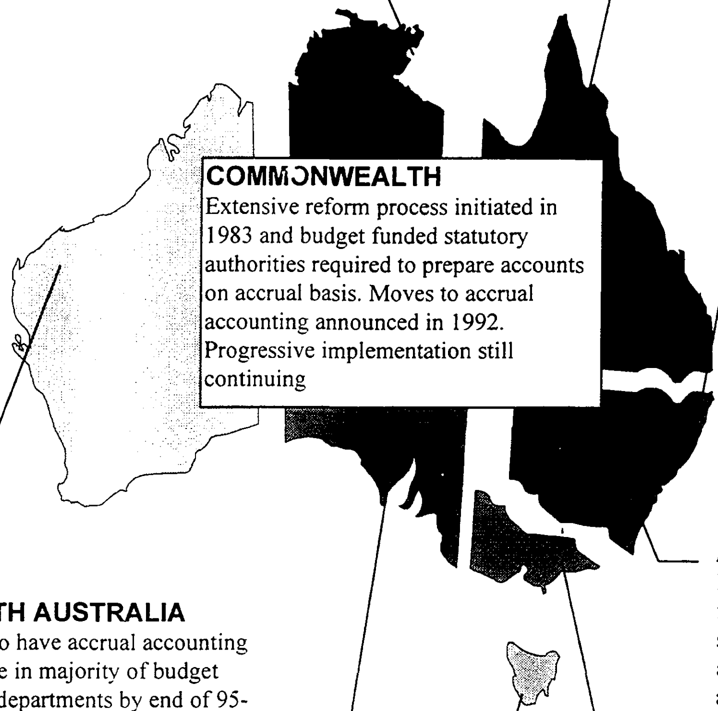
- that the Commonwealth's departments and agencies introduce accrual accounting which takes account of longer-term costs and returns rather than cash flows;
- that the full Budget be moved to an accrual accounting basis by 1998-99; and
- that the Commonwealth government move to 'whole of government' accounting, taking all possible assets and liabilities into account, in order to create a 'balance sheet' along the lines of reforms adopted in New Zealand.

As the *Australian Financial Review* (21 June 1996) observed, "If implemented, the changes mean the Budget would bring the Government's accounting practices into line with those of large companies".

PROGRESS IN AUSTRALIAN JURISDICTIONS - AT A GLANCE

NORTHERN TERRITORY
Has already published several 'whole of government' financial reports which cover administrative responsibilities, GFS and government purpose classifications. Some accrual type information presented, however government largely follows uniform reporting standards on GFS basis

QUEENSLAND
Plans production of a preliminary aggregate Statement of Financial Position for 94-95. Still undergoing progressive movement to accrual accounting from cash basis.



WESTERN AUSTRALIA
'Whole of government' unaudited consolidated financial statement produced for the period ended 30 June 1994. Departments still moving towards full accrual accounting and reporting

COMMONWEALTH
Extensive reform process initiated in 1983 and budget funded statutory authorities required to prepare accounts on accrual basis. Moves to accrual accounting announced in 1992. Progressive implementation still continuing

NEW SOUTH WALES
Published first 'whole of government' report in 1989, and first consolidated financial statements in 1994. Has completed full adoption of accrual accounting for whole public sector since 1992. Is the only Australian state to have its whole of government statements audited

AUST. CAPITAL TERRITORY
Moving to full accrual based consolidated financial reports. Planned for 95-96 statement to be in whole of government accrual based format, and that this will be audited. Proposals to have 96-97 consolidated financial statements on full accrual basis, incorporating accrual budgeting and accounting.

SOUTH AUSTRALIA
Plans to have accrual accounting in place in majority of budget sector departments by end of 95-96, and all entities producing accrual based financial statements for 96-97. First whole of government statements planned for 96-97

VICTORIA
Accrual based reporting has been adopted with three year staged introduction beginning in 1991-92. Audited accrual based reports produced by all but three departments for 94-95. Preparation of trial Consolidated Financial Report (unaudited) to be done for 94-95 and scheduled for completion March 1996

TASMANIA
Is moving towards accrual but is only in early stages in assessing value of preparing 'whole of government' reports, consequently no consolidated reports have been produced to date. Moving towards progressive implementation of accrual accounting in government departments

3.6 Australia at the state level [30]

Public sector reporting in State and Federal jurisdictions in Australia incorporates varying degrees of cash, modified cash and accrual accounting.

Victoria

In Victoria, the move from cash-based to accrual-based reporting by departments is well under way. Accrual-based reporting has been adopted with a three-year staged introduction which began in 1991-92. All but three departments produced audited accrual-based reports for 1994-95. The remaining departments will fully comply with AAS 29 in 1995-96.

The Treasurer, Mr Alan Stockdale released a trial consolidated financial report of Victoria's public sector for the year to June 1995, using the same format as that used by major companies. The report includes financial information on bodies controlled by the Government however is not subject to audit by the Auditor-General.

The Government aims to bring full accrual accounting to the 1996-97 State Budget. Mr Stockdale stated that the move to accrual accounting would "strengthen accountability by giving greater understanding of the size, value and condition of the State's assets". [31]

Queensland

The Queensland government is moving from cash-based financial reporting to accrual-based reporting in accordance with Australian accounting standards and proposes to produce a preliminary aggregate Statement of Financial Position for 1994-95.

A review of public assets is currently underway and the deprival valuation method is being applied to all significant assets, including heritage assets.

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[30] For further details see Joint Committee on Public Accounts, Commonwealth, Parliament (1995), *Financial Reporting for the Commonwealth: Towards Greater Transparency and Accountability* [Appendix iv].

[31] Mark Skulley, *Full Accrual Accounting for Victoria*, Australian Financial Review, 6 June 1996 p. 7.

South Australia

A move from cash-based to accrual-based accounting is currently under way. The SA government plans to have accrual accounting in place in the majority of budget sector departments by the end of the 1995-96 financial year, and all government-controlled entities will be required to produce audited, accrual-based financial statements for 1996-97.

While the process is in its very early stages, it is planned to have the first 'whole of government' report produced in 1996-97. The report will include GBEs.

While it is proposed to audit whole of government statements, the first report in 1996-97 may not be audited depending on the reliability of underlying information.

Western Australia

For the period ended 30 June 1994 the WA government published an unaudited 'whole of government' consolidated financial statement. Portfolio departments are moving from audited cash-based statements to full accrual accounting processes.

The 1994 Consolidated Financial Statement includes general government, public trading enterprises, financial enterprises and other entities. GBEs are included as public trading enterprises, and, as with all agencies, their presentation is fully consolidated. Land is included as valued by the Valuer-General. Data on buildings and plant and equipment is also included. It is intended that, in due course, the annual 'whole of government' consolidated financial statements will be audited, and the audited reports tabled.

Tasmania

Cash-based reports are prepared in Tasmania. The Tasmanian government is moving towards the adoption of commercial accounting principles for government departments, with accrual accounting being progressively implemented. However, the government is only in the early stages of assessing the value of preparing 'whole of government' reports, and other priorities are taking precedence over these initiatives.

Northern Territory

The NT Treasury supports the adoption of comprehensive 'whole of government' reporting and already published several 'whole of government' financial reports. Except for government business divisions which have adopted accrual accounting, the government sector uses uniform reporting standards on a Government Finance Statistics basis.

Three 'whole of government' reports are prepared in the NT, covering the administrative responsibilities, GFS and government purpose classification, each of which is predominantly cash-based. In addition, accrual-type information is presented for all significant assets and liabilities.

The NT Treasury believes that there are a number of technical issues which must be resolved relating to 'whole of government' reports on an accrual basis before such reports can be usefully be prepared.

Australian Capital Territory

The ACT government is moving from cash-based statements to full accrual-based consolidated financial reports. The 1994-95 balance sheet will be in accrual format and the Auditor-General's comments will be sought. The 1995-96 statement will be in the form of a 'whole of government' accrual-based report and it is anticipated that this statement will be audited. The ACT government proposes to have the 1996-97 consolidated financial reports prepared on a full accrual-based system incorporating accrual budgeting and accrual accounting. The 1996-97 financial reports will also be fully audited.

The ACT Government is still making final judgements on whether or not GBEs will be fully consolidated in 'whole of government' reports. It intends to table a consolidated financial report for 1996-97.

FINDING AND CONCLUSION

In summary, it has been generally acknowledged that of all the government jurisdictions both worldwide and within Australia, which have been in the process of implementing accrual accounting over the past ten to fifteen years, New Zealand and NSW are equal leaders at this point in time, having successfully produced audited consolidated financial statements for the 'whole of government'.

For NSW, this is a significant achievement in the general context of government reforms taking place globally.

CHAPTER FOUR

MAJOR ISSUES TO BE RESOLVED

4.1 Introduction

As this report testifies, the implementation of accrual accounting in NSW has not been without its problems. Most have stemmed from being the pioneering state in Australia and from the inadequate up-front planning of the whole exercise.

4.2 Asset valuation: Why is asset valuation a problem?

In adopting accrual accounting agencies have been forced to value assets because assets form a major part of the 'statement of financial position' - i.e. 'what the agency owns'(assets), 'what the agency owes'(liabilities), and 'what the agency is worth'(assets minus liabilities). Many agencies have encountered significant difficulties, first in identifying the asset, and then in trying to place an appropriate value on it.

In the public sector, asset valuation is a problem for the following reasons:

- Traditionally, cash accounting meant that many public sector assets were never recorded or acknowledged in any way (so identification is the first problem);
- Some assets, such as crown land, historical buildings and collections, were simply accepted as part and parcel of providing public services: they have a historical, colonial base and never had a value to begin with (so what value to we place on them?); and
- Many public assets, for example, buildings, roads, gardens and parks, will never be sold because they have 'community service obligations' attached to them, that is, the government is obligated to provide the community with certain services (so what value do we place on these?).

It is probably in this latter category that most of the current problems and issues in respect of asset valuation reside.

Initial identification problems have largely been overcome. The PAC survey[32] indicated that respondent agencies were confident that their asset registers were sufficient to allow them to formulate total asset management plans[33]. Many have recognised the benefits of having asset registers, and feel that they are more in control of their assets. Because rigorous stocktaking procedures were undertaken at the introduction of accrual accounting, there is now a better appreciation and understanding of exactly what kinds of public sector assets are currently available and owned by the State, and for most, a reasonably accurate idea of how much these assets are worth.

It is fair to say that the figures which quantify public assets in the consolidated 'whole of government' financial statements are a fair reflection of the value of public sector assets held by the State. In general, the process of identification and valuation has been smooth, and valuations, in particular, have been sorted out and agreed upon by accountants, auditors and valuers alike.

However, for some classes of assets, such as those to which a 'community service obligation' is attached, such as roads, freeways and highways, there is still a significant amount of work to be done in the area of finding an appropriate, and generally accepted, valuation. This will add further credibility to the accuracy and attestability of public sector assets as a whole.

The Committee was given a number of examples in relation to the difficulties encountered in valuing assets, such as infrastructure assets, land under roads, heritage assets, parks and gardens and collections (art, museum, botanical).

The first example relates to land under roads, and is from Mr Ron Christie, Chief Executive, Roads and Traffic Authority:

> *I agree with the valuation of land under roads as a concept. I do not believe it is fair to exclude the value of a valuable asset which the public sees as being acquired from time to time and passing into RTA hands, without some attempt at valuation. I think Treasury now also agrees that there should be some recognition given to that asset. The question now is how valuation is to occur.*
>
> *Yes [the $14.8 billion figure for land under roads[34] is still being discussed]. I give an analogy of the way I look at it as a manager. When one does an estimate for a project the rule we*

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[32] See Chapter 5.

[33] See Chapter 5 of this Report - *Have Agencies Established Adequate Asset Registers which Form the Basis for Total Asset Management Plans?*

[34] See PAC Report No. 99, Chapter 1.

have always given people is that if you leave an item out totally and ignore it, that is a pretty bad and serious situation because it can totally misconstrue the whole estimate. That analogy obtains with the value of land under roads in that if the item is ignored completely a completely false impression is given of the asset base of the RTA. On the other hand, if some recognition is given it may need to be discounted. It may not be as accurate as it could be and there may be a dearth of valuation techniques for that particular asset under the infrastructure. However I believe it is a bigger problem if it is ignored completely.[35]

Further testimony to the difficulties in valuing land under roads, and support for the above comments, came from the Valuer-General, Mr Peter Cunningham:

It is my understanding that the valuation of $14.8 billion is based mainly on the value of adjoining land and is derived from the valuations that we make of all that land for rateable purposes. The problem for a valuer is that the land under a road cannot be developed as can the land that actually adjoins the road. In fact, to a certain extent the value for land that adjoins the road captures elements of value because of the existence of the road. So, to value the road, for example, in the city of Sydney at the same value as the land adjoining it assumes that you can do something which is quite impossible, which is to develop that land to a similar extent.

I do not believe that it is proper to value it [land under roads] at the same value as the adjoining value. I think the valuer has two particular problems in this instance. One is that in determining a value for a road or for all roads we are looking for a realisable figure. It is obviously not possible to realise the figure if it is based on the assumption that you can develop a road - or a park or botanic gardens or anything like that - because you cannot. The other problem is that the accounting guidelines require that you should be able to reliably measure the value of the particular asset. In the case of land under roads, that is very difficult. A further problem is that when the RTA buys a row of houses to demolish for a main road, obviously it has to pay the going rate for houses. That might amount to millions of dollars per hectare, but then it demolishes the houses, turns the property from residential property into road or perhaps just the fringes of a road and it is no longer worth what it paid for it. So, there is a real valuation problem in that exercise.

I think the main outstanding issue is the valuation of land under roads. As far as the valuation of other types of public sector assets is concerned, I think the principles and the practice have been sufficiently well established now that when we provide a valuation we are saying that the valuation of that particular property - land and buildings - represents what it is worth or what could be realised as the value of that property if it was put on the market. Obviously in the case of Parliament House that is totally theoretical and hypothetical. For the majority of properties I think that at least represents an understanding to the management of the property of what it is worth. Certainly in all government trading enterprises that is essential so that they know what the assets are worth. It needs to include land because the land is obviously part of the asset. The real problem is resolving this question of land under roads. It has been the major stumbling block to all of this valuation

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35 Evidence to Committee p. 2-3.

for accrual accounting process for a number of years and it is one which both the accounting and valuing professions hold quite different views.[36]

Natural assets provide another example of how particular characteristics of an asset can provide dilemmas in their valuation. Dr Hans Drielsma, Managing Director, State Forests, outlined this in the case of State Forests:

It [the recognition and valuation of land] has been quite a vexed question for us and it has not been adequately resolved at this stage. We value all our accounts as we go along. We have on our accounts areas of land that we have purchased, but the appropriate valuation on State Forests balance sheets, if any, of Crown lands that we manage is unresolved. That has been a matter of qualification by the Auditor-General in the most recent annual accounts. This year we are engaged in a process with the Auditor-General and we are getting external advice on developing an appropriate approach. As a commercial organisation we obviously have an interest in a valuation that reflects our ability to conform commercially against that valuation, which raises what the appropriate mechanism for valuation ought to be and how, perhaps other non-commercial values might be taken into account.

We have been leading the way in the last few years to develop methodologies for plantations and you will notice from our annual accounts that we value our plantations on a market value basis that has been agreed with the Auditor-General. We are reviewing it at the moment. An exposure draft has been put out by the Accounting Research Foundation to examine appropriate ways of valuing forests, particularly plantations, and I think it is fair to say that our current methodology is largely consistent with that.

But when we translate that into the native forests, the methodology becomes significantly more complex. We have decided that probably a DCF [Discounted Cash Flow] process is the most appropriate and perhaps only feasible one to deal with native forests, which has raised issues as to whether or not - and if not why not - that same methodology should not be applied to plantations. That is part of the process we are considering this year with the Auditor-General, who seems to be leaning in the same direction.[37]

The valuation issue also centres on the previous assumption that assets belong generally to the State. Now, under the requirements of accrual accounting, assets must be identified as belonging to a particular agency and valued accordingly. This still brings them onto the public accounts as being assets of the State, although classified, and maybe valued, differently. There are however difficulties with this process where the asset is provided to the public as a community service, as noted by Mr John Shanahan, Audit Partner, Deloitte Touche Tohmatsu:

We then go back to the RTA. The RTA has the land under the road. We need the land under the road if that asset [the road] is to provide us with future services. Accrual accounting does not suggest that the asset must have a value. This morning we heard the example of the lane outside the Governor Macquarie and Governor Phillip tower complex. That could be sold for

36 ibid. pp. 11-13.
37 ibid. pp. 21-22.

the commercial development rights. It had a particular value in that circumstance. The land down George Street could not be sold. We still need to move traffic down George Street. You are looking therefore, at two different approaches to valuing land which appears to have the same sort of utility; one was a land in the CBD, one was a thoroughfare in the CBD.

With respect, the asset was always there but its valuation changed remarkably once we said "We are no longer going to use it as access to that building. We can now put it to what we can sell it for." Now if we sold the Royal Botanic Gardens as a development site, it would be worth a fortune. As botanic gardens it is not worth nearly as much unless we start saying "Yes, we recognise that as a community service objective. We want to be able to wander in the gardens and refresh ourselves". Accrual accounting finds it very hard to attach a value to that.

We can take a hospital or a school, and the Royal North Shore Hospital was mentioned earlier this morning. The use of the Royal North Shore Hospital site has not changed. The values across the road from it have gone from $65 million down to $15 million and the hospital still is as equally valuable as it ever was.

If we take another hospital, say Westmead Hospital, with the new centre of focus being Campbelltown, and decided to sell Westmead, not as a functioning full-service public hospital but said, "Let us sell it to one of the private health care groups", you could have a complete hospital building and you could then run it to make whatever profit you like out of it. I suggest that would give us a very different value for Westmead Hospital to that given by the Department of Health. They are not looking to sell it; they are looking to provide hospital services.

If I were to buy the hospital or the school, I would then use it as a moneymaking venture and would project forward cash flows and discount them back to the present value, whereas with the Royal Botanic Gardens it is difficult to think that I would charge everybody for access to it.[38]

The Committee acknowledges that the issue of asset valuation remains one of the most difficult to deal with in implementing the concepts, principles and practices of accrual accounting. The problem is peculiar to the public sector, in that the public sector owns large parcels of assets which have, by their very nature, a community service objective and obligation. The valuation of these is an issue which is not faced by the private sector, and therefore the accounting guidelines and standards are largely inadequate or silent in this area.

Another area of difficulty, which is again peculiar to the public sector, is the issue of the provision of infrastructure, and its subsequent valuation. Again the issues arise because the government has certain obligations to the community to provide certain goods and services. Historically these services are ones which could and should only be provided by the government, having been paid for by rates and taxes and benefitting all of the community.

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38 ibid. pp. 53-54.

Infrastructure assets such as tunnels, roads and freeways, have previously been dealt with in detail by the Committee. The Committee has tabled in Parliament a series of reports on the provision of infrastructure in the public sector and has noted the lack of accounting standards which could apply to infrastructure, causing uncertainty about the most appropriate accounting treatment. The matter is further discussed in Chapter 5 of this report.

A final example of the problems in asset valuation occurs in relation to the valuation of heritage assets and museum and art collections, as indicated by Mr Shanahan:

> *When you come to assets such as the collection of the New South Wales Art Gallery, which is valued at a nominal $1, we all know that is wrong but in the accounting context that is not going to generate any cash flows or any charge for entry to the gallery. I would like to buy it for $1 but no one will sell it to me for that.*
>
> *The gallery values its collection on the basis that it is not going to be sold. The bulk of that collection is in the storage vault underneath and comes out on rotation. The collection is a valuable asset and is worth more than $1.*
>
> *A disclosure saying it is worth just $1 waves to an accountant that this is deliberately wrong. You are expected then to go and read the note and say "The New South Wales Art Gallery collection, I think it is worth $20 million". You might think it is worth $15 million, someone else thinks it is worth $30 million. We make our decisions based on our own assessment of the place. That is not a way by which we are going to impose any uniform performance measurement or assessment.*[39]

In summary, the Committee recognises that whilst a significant proportion of public sector assets have now been identified and valued (and this has been one of the major achievements of the introduction of accrual accounting), there are a number of classes of assets where problems are still being experienced.

It is acknowledged that the guidelines developed and implemented by Treasury at various stages during the implementation[40] have greatly assisted in easing initial difficulties. However, there is still a substantial amount of work to be done in arriving at uniform and agreed methodologies for valuation of those assets which carry significant amounts of community service obligations.

Mr John Shanahan sums up the general difficulties in respect of asset valuation which need to be seriously addressed by the accounting and valuation profession if public

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39 Evidence to Committee, p. 57.

40 See Appendices 3 and 4 which gives detailed explanations to agencies on the methods and basis of asset valuation e.g. the concept of the deprival method.

sector assets are to be even more meaningful to Parliament and the public, and are to be used in a positive, considered and planned way to make future decisions:

> *I think the $1 tag is just waving a flag to an intelligent user of the accounts that this is wrong and you should look into it. On the adjacent land, we have to revalue Government House because we will be allowed to use it three days a week. We do not even know how to value the Art Gallery and Mrs Macquarie's Chair. So on that basis the value of the Botanic Gardens would be uncertain. The St Leonards railway site was sold for $15 million. It was worth $65 million. I would happily accept $50 million for the Botanic Gardens. If I could buy it as a development site I would pay much more than $50 million. But you know that you do not ever want it as a development site so do you say it is worth $10 million? This morning State Forests put a value of nearly $40 million on its 83,000 hectares of pine plantations. There is four times the area of native forest at an historic cost of $50 million.*
>
> *We really have no valid way of assessing how well we are managing that native forest. With the numbers we are producing in our accounting reports, I would expect that the native forest has to be worth at least as much as the quarter-of-the-size pine plantations. We have not got that sort of information. The reason they get a qualification is that they have different valuation bases for what is essentially a fairly similar asset - the native growing stock. If we show the Botanic Gardens and the collection at the Art Gallery as worth $1, we are not giving ourselves an appropriate basis on which to assess the performance of public sector management.*[41]

Elsewhere in this Report, the Committee has indicated that there is a serious need for the parties involved - agencies, Treasury, accounting professionals, valuers and auditors - to give greater priority and attention to the resolution of the matter of asset valuation. The examples contained in this report are likely to be a minute sample of the very real problems which currently exist. The longer these valuation issues remain unresolved, the more likely it will be for Parliament and the public to call into question the contents, or otherwise, of the public accounts, and the very achievements that have been made so far.

[41] Evidence before Committee, p. 61.

RECOMMENDATION

The Committee strongly urges the accounting bodies and associated professions to resolve the issues identified in relation to the valuation of those public sector assets to which there is attached a high level of community service obligations and objectives, the nature of which makes them less likely to be able to be valued by more conventional or commercial valuation practices and principles.

The professions involved must recognise that the valuation cannot be encompassed by what is essentially private sector accounting standards. There is a serious need to develop, in consultation with all relevant public sector parties, accounting standards which more adequately reflect the unique nature of the public sector and the services it provides to the general community by way of its assets.

4.3 Capital costs and charging

In Chapter 2 of this Report, the Committee reviewed the issues of capital costs and the funding of non-cash items. These issues revolve around the question of whether it should be Treasury or the individual agency which bears the costs of capital and of those newly identified non-cash items such as depreciation and employee entitlements.

Large amounts of capital are expended on government initiatives and in building public assets. If the true costs of services are to be disclosed, then ideally the cost of the capital component injected into providing these services should show in the financial statements of the agency. For example, in the case of Darling Harbour, the capital cost of building the complex is still held by Treasury, and the repayments of the debt to service this capital are met by Treasury. This allows the accounts of Darling Harbour to show all the revenue earned, but not the other side of the story: the fact that the capital cost is still a large debt incurring many millions in uncovered interest. If Darling Harbour were to account fully for the cost of the complex, and then show all revenues and liabilities, a truer picture of the cost of the services to the public would be given. Darling Harbour would be shown to be making huge losses. This would allow parliaments, governments and indirectly, the public, to make better informed decisions about whether similar future projects are worthwhile.

While central agencies such as Treasury continue to pick up the capital costs of many government projects, the agencies themselves are benefiting from the capital in the generation of revenue, and are not showing the corresponding costs of that capital.

There is a need to work out who is responsible for disclosing the cost of capital whether it be Treasury or the agency. In general, practitioners would consider that if public sector agencies are to be more truly in line with the practices of the commercial sector, then they should disclose the capital costs in their accounts. Private sector businesses must do this in order to fully disclose their profit or loss, to make decisions on future business ventures and projects, and to more accurately price their services and goods to recover the full costs of production.

Some agencies have asked the question that if they are not bearing the costs of the capital, then why are they bearing the non-cash item associated with its depreciation? The same can be said for superannuation, where employment decisions by agencies must take into account the full costs associated with employment of a person, even though superannuation expense is funded largely by Treasury as part of a pooled funding arrangement.

Treasury are undertaking further work in this area, and have released a discussion paper in relation to capital charging. The Committee looks forward to the resolution of this matter in the near future.

4.4 Lack of Accounting Standards

The lack of accounting standards is an issue which is also a product of pioneering into unexplored areas. In many cases, current accounting standards have been found wanting in relation to a number of issues which have arisen as the result of the introduction and adoption of accrual accounting.

In general, the standards focus on private sector and commercial businesses which have profit as their main objective. On the whole, governments do not exist for the same purposes, even though many government services and agencies are adopting more commercial practices and business orientations. Essentially, government agencies exist to provide a certain level of community services which the private sector has traditionally and historically been unable or unwilling to provide.

Accrual accounting in the public sector requires consideration of a number of particular issues, not the least of which is the issue of asset valuation, already dealt with above. The public sector is unique and deserves greater attention from the accounting standard setters than is currently being given. It does not deserve 'bandaid' solutions, such as the amendment of standards to read 'to include the public sector'. Accounting in the public sector is open to greater scrutiny from external parties, and each and every transaction has the potential to affect large amounts of public moneys and assets - the problems cannot be fobbed off lightly.

The problems encountered are best summed up by Dr Hans Drielsma, Managing Director, State Forests:

> *We think it is very difficult. There is not an accounting standard. Even going down the path with plantations we took a risk. There was no standard to guide us. We took a decision three or four years ago when we said we just cannot wait, we have to do something. So we did it. We had long discussions with Auditors-General and others, and at that stage we came up with a system that people are happy to sign off on. We have been leading the way. Doubts are being raised about that now. We have a discussion paper which helps clarify some of those issues. We will probably still be leading the way because we might be moving to something that is going to be somewhat different from what is being put up. With native forest it is very difficult to take a path when there is no methodology and when the data that you are likely to have to put together is enormous. So you do not want to go down the wrong path. You want to sort out what is going to be an appropriate methodology. We do not have that but we are determined we are going to come up with something by the end of this financial year.*[42]

4.5 Budgets and Parliamentary Appropriations

The Committee notes the work done in other jurisdictions to resolve the issue of parliamentary appropriations on an accruals basis. Historically, agencies have received 'votes' of money from the public purse (the pool of money coming from rates, taxes and so on). These votes (also known as appropriations) have been cash based, that is, they represent a sum of money to spend on providing services to the public. In changing to accrual accounting, there is a need to consider a change to the appropriation procedures of Parliament to align them with the accrual process.

Doing this allows the budget process to extend out beyond its current twelve months, and gives a picture of projected expenditures and cash flows. It recognises that government agencies carry out programs of services which continue beyond twelve months. This thereby allows a budget to be set for the full term of the project without dividing it into timed segments, the funding of which depends on the next allocation of cash from government. Aligning the appropriation process with accruals concepts also tends to prevent the 'spend it or lose it' mentality which is associated with cash appopriations, and ensures expenditure decisions and resource allocation are based on

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42 ibid. p. 30.

outcomes. On the whole, there is a better appreciation and measurement of agency performance over a longer period of time.

The Committee notes the current situation in New Zealand[43]. New Zealand has been publishing measurement data on outputs for a number of years and has incorporated these measures in its budget process, with funding being allocated on the basis of negotiated output quantities and price. New Zealand has also moved to contractual budgeting, which is an extension of the outputs measures requirement and represents a commitment by a Minister or agency to provide certain outputs or achieve certain outcomes given the level of budget support.

The Committee also notes the recommendations covered in a recent report by the Comptroller and Auditor-General (National Audit Office), United Kingdom which details how resource or accruals budgeting is proposed to be implemented in the UK in the year 2000 and beyond.

FINDING

The Committee's terms of reference for the inquiry into accrual accounting did not extend to a full and detailed review of current parliamentary appropriation practices, nor to a review of problems and possible options for future change. However, the implications of accrual accounting for the budget process cannot be overlooked as it is a part of embracing a fuller implementation of the accruals concept of accounting.

[43] See Chapters 2 and 3 of this report.

FINDING

Essentially, there are four major issues which have arisen from the process, and which, to date, have yet to be satisfactorily resolved. They are:

- asset valuation;
- acceptance of responsibility for capital costs and capital charges;
- inadequate professional standards for particular public sector issues such as asset valuation; and
- linking accrual accounting to the parliamentary budget and appropriation process.

RECOMMENDATION

The Committee strongly recommends that Treasury urgently review the budget process, in consultation with appropriate professional bodies and agencies, and that it explore the possibility of introducing accrual budgeting appropriations at the NSW Parliamentary level.

CHAPTER FIVE

A REVIEW OF THE IMPLEMENTATION OF ACCRUAL ACCOUNTING IN NSW

5.1 An introduction

The NSW public sector has made a significant investment in introducing accrual accounting and reporting. This investment represents significant amounts of time and money in converting both technology, systems and attitudes from the traditional government cash accounting base to that of accrual accounting. As with any major change, experience various levels of acceptance and resistance are likely to be experienced within agencies. The success or failure of the change can often be measured by surveying the participants, post-implementation.

In its earlier submission to the Committee, Treasury indicated that it had conducted a post-implementation survey in 1992 of a number of selected Budget Sector agencies which had converted to accrual accounting. According to the submission, the main purpose of the review was:

> *....to identify all major issues and problems under the new accrual accounting regime so that appropriate action could be taken to address them across the whole of the Budget Sector. The focus was on five key matters, viz the reliability of the financial information produced by the systems, the adequacy of the system maintenance procedures, the documentation of policies and procedures, the use of accrual information by management and the competency of the accounting and finance staff in operating an accrual based system.*

The review highlighted a number of major problems still existing within some agencies, including the fact that internal reporting was continuing to be on a cash or limited accruals basis; that operational managers still requested cash-based information rather than accrual for decision-making purposes; that there was insufficient commitment to accrual accounting by senior management; and the need for a complete revision of work practices and procedures in some agencies.

Treasury acknowledged that the findings were to be expected in the initial stages of a conversion from a relatively simple cash system to that of a fully integrated financial management model. The review was used by Treasury as a basis for formulating strategies to further assist agencies in combating their problems and in maximising the benefits of their new accrual accounting and budgeting systems. These strategies included additional courses; assistance in reviewing and modifying internal management reports; general advice and assistance in the documentation of policies and procedures; encouragement for agencies to continue the training of accounting and finance staff; and emphasis on strengthening and improving communication between accounting staff and information users to ensure user needs are met.

In April 1996, the Committee conducted its own survey, covering 62 NSW Budget Sector agencies which had converted to accrual accounting and reporting.

In total, the Committee received 51 responses providing an excellent response rate of approximately 82%. For various reasons, only 45 responses could be used to compile general observations and undertake general statistical analysis. However, the diverse range of agencies responding was sufficient to enable the Committee to gain a good indication of the success or otherwise of the implementation of accrual accounting, and to assess the progress since Treasury's earlier post-implementation review.

The survey enabled the Committee to draw general conclusions, and to report and comment on the Terms of Reference and raised the following issues:

- whether the implementation of accrual accounting in the NSW Budget Sector has been carried out effectively;

- the adequacy of computerised financial management systems introduced by agencies for the purposes of accrual accounting and whether these systems integrate into a total management system;

- the extent to which information is used for management and decision-making at the agency and whole-of-government level;

- whether sufficient training has been provided to both financial and non-financial staff, and to establish whether financial managers in agencies possess the appropriate level of skills and competencies to provide financial advice and support to senior management; and

- whether adequate asset registers, which form the basis of Total Asset Management plans, have been established.

5.2 Key statistics from the survey at a glance

	Percentage of Respondents*	Costs $
Accrual accounting implementation complete	80%	
Agencies who supplied quantified or estimated costs of implementing accrual accounting:	77%	
quantified costs		15 663 350
estimated costs		36 533 800
total costs		52 197 150
maximum quantified cost		8 700 000
minimum quantified cost		35 000
maximum estimated cost		20 000 000
minimum estimated cost		10 000
Accrual Accounting Implementation Costs Breakdown:		
Information Technology	51%	21 216 000
Human Resources	55%	10 954 000
Consultants	55%	12 438 008
Other	42%	5 856 055
Agencies coped well with change to accrual accounting	(20 comments) 65%	
Treasury provided additional funding and support for implementation	(19 comments) 63%	
Ongoing costs most identified with accrual accounting		enhancing computer systems staff training
Agencies received value for money from accrual accounting	(27 comments) 74%	
Agencies purchased computer equipment as a result of the implementation of accrual accounting	62%	
Computer costs Breakdown:		
Hardware	53%	4 655 325
Software	60%	4 400 905
Staff Training	46%	883 130
Systems Development	55%	5 748 308
Agencies who say their systems meet their needs	75%	

	Percentage of Respondents*	Costs $
Agencies who would have updated their systems regardless of the implementation of accrual accounting	80%	
The percentage of agencies who indicated that Treasury training was: appropriate compulsory ongoing	 46% 6% 13%	
Agencies costs for staff training		4 888 430
Agencies costs for engaging consultants		12 130 457

** Denotes that percentages have been calculated on responses received out of 45, unless otherwise indicated*

5.3 Overall success of implementation

The success of the implementation of accrual accounting is borne out by the following:

- The Australian Bureau of Statistics acknowledges NSW as the only jurisdiction able to produce accruals based financial information data for final annual Government Financial Statistics, forward estimates Government Financial Statistics and quarterly data.

- The Auditor-General for NSW, Mr Tony Harris, acknowledged at a Public Accounts Seminar[44] that when the whole of government report [came] out for 1993-94 on an audited basis, it signified that NSW is more advanced in accrual accounting than any other jurisdiction in our region.

However, the Committee notes that the success is qualified. The process of implementation would have been enhanced had accepted principles of project management been in place at the start, especially project planning and budgeting. This may have prevented or minimised a number of problems expressed by agencies.

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44 Public Accounts Committee - *Proceedings of the Seminar on Accrual Accounting - The Scorecard to Date, 13 December 1994. Report No 89. February 1995* p .53.

5.4 Costs of implementation

FINDING

The Committee's survey identified costs attributable to the implementation of accrual accounting in agencies as $52.19 million. However, the Committee concludes that a final dollar figure for costs attributable to accrual accounting is unlikely ever to be reached as agency records in this respect are unreliable. The Committee estimates that the cost is likely to be in the vicinity of $100 million.

5.5 Integration and adequacy of systems

Agencies have made positive progress in respect of the integration of their computerised systems as part of a total management system. However, not all agencies have this ability at present.

5.6 Use of cash information

There is enough evidence to suggest that agencies continue to maintain separate cash information systems - which may or may not 'integrate' into their accrual systems. Their reason for doing so is to satisfy both internal reporting requirements to management, and to meet the NSW Treasury's requests for cash information to supply the Australian Bureau of Statistics.

The continuing practice of funding agencies through cash-based appropriations appears to be perpetuating the view that Treasury considers cash information to be superior. It also appears to be hindering a more complete acceptance and internal use of accrual information by agencies.

Although external reporting of accrual information has risen, the internal use of such information by agencies would be enhanced if the external Parliamentary appropriation system were under the accrual concept, and if the end product of the process, the whole-of-government financial statements, together with the audit report and opinion of the Auditor-General, were tabled in Parliament.

5.7 Accounting training, skills and competencies

Training offered by Treasury has been sufficient to ensure that the basic theories and concepts of accrual accounting have been understood and communicated to agency staff, both accounting and non-accounting.

Accounting staff in the public sector are now at a high skill and competency level, with most being able to put into practice the skills and knowledge from tertiary education. There are still improvements to be made, and the development and adoption of competency standards for accounting staff will further guarantee the high quality of accounting advice and assistance.

5.8 Management and accounting for assets

Guidelines and policies developed by Treasury have significantly assisted agencies in the development and implementation of asset registers, and in the adoption of total asset management plans. They have helped agencies to identify, classify, value and depreciate a significant proportion of the State's public assets. Agencies are now able to assess the true cost of services using the greater level of information generated under the accrual method of accounting.

Some agencies are still experiencing difficulties in valuing some public assets, and others continue to have problems in defining and accounting for the level of capital cost which should be included when calculating the true cost of their services. There are no accounting standards to cover these issues, nor are there any to cover the issue of the combination of private and public funding of public infrastructure. This is causing delays in providing a more thorough and complete set of whole-of-government statements as some assets are still not adequately valued or are omitted because of the technical accounting issues which have yet to be resolved.

5.9 Terms of reference

5.9.1 Has the implementation of accrual accounting in the NSW budget sector been carried out effectively?

The process of implementation is largely complete. Only 13% of survey respondents indicating that they had not finished the implementation phase, but even these respondents were on average 80% complete.

5.9.1.1 External Acknowledgment of Effectiveness

In its paper "*Introduction of an Accruals Basis in Government Finance Statistics*"the Australian Bureau of Statistics (ABS) noted that there have been a number of developments leading to an increased demand for the Government Finance Statistics (GFS) to be produced on an accruals basis. One of these developments is the movement by Australian jurisdictions towards accrual budget reporting and accounting, and the ABS acknowledges the lead which NSW has in this area:

> *The extent of this movement has varied greatly between jurisdictions, with the New South Wales Treasury (and more recently the West Australian Treasury) taking a leading role in the production of accrual based financial statements and budget information.*
>
> *All jurisdictions have stated intentions of (at least) producing financial statements on an accruals basis, but at the time of writing the only jurisdiction which is capable of producing accruals based financial data for final annual GFS, 'forward estimates' GFS and quarterly data would appear to be New South Wales.*[45]

Further external recognition of the effectiveness of the implementation comes from Mr John Shanahan, Audit Partner, Deloitte Touche Tohmatsu, who believes that much of the improved effectiveness in the public sector, that is, improved decision-making, can be assigned to the implementation of accrual accounting:

> *At a seminar in 1988 Treasury was of the view that accrual accounting was not necessary. Here we are eight years later and I believe that the New South Wales public sector has fully adopted accrual accounting, and I believe from my experience, when I see the type of decisions being made by what I would like to call the younger generation of departmental management, you have to ascribe a lot of the improved effectiveness to accrual accounting.*[46]

And as stated previously, acknowledgment from the Auditor-General for NSW, Mr Tony Harris at a Public Accounts Committee Seminar[47] that, when the whole of government report [came] out for 1993-94 on an audited basis, it signified that NSW was more advanced in accrual accounting than any other jurisdiction in the region.

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[45] Australian Bureau of Statistics, *Introduction of an Accruals Basis in Government Finance Statistics* - 1995 Government Finance Statistics Conference, Conference Item 4 p. 2-3.

[46] Evidence to Committee, 6 March 1996 p. 52.

[47] Public Accounts Committee - Proceedings of the Seminar on Accrual Accounting - The Scorecard to Date, 13 December 1994. Report No 89. February 1995. p. 53.

5.9.1.2 Process Effectiveness

There are two generally accepted ways in which significant change can be implemented. The first is sometimes referred to as a 'break-through' or 'crash-through' approach[48]. This means that a new concept (in this case accrual accounting) is introduced quickly over a short period of time. The second is referred to as an 'incremental approach', which introduces significant change in smaller doses over a longer period of time.

The crash-through approach is often used in the commercial private sector environment to bring about significant change quickly, as it requires management to accept and implement what appear to be initially impossible roles and deadlines, and challenges them to achieve targets. It takes less time, and benefits may be realised earlier.

The incremental approach takes longer because implementation is done by stages, gradually introducing additional new procedures and concepts over time. It can engender a higher level of acceptance from those who are implementing the new procedures as they have time to adjust to new concepts and requirements. It also allows time to plan how the change will take place, including detailed estimates of costs and the likely impacts of the change on those who will be required to undertake the new procedures.

Crashing through can be more expensive and is less likely to enhance support and acceptance from the target user groups (e.g. agency managers). Often the speed to implement and meet deadlines overtakes a more considered approach, which would have included strategic planning, considering and evaluating options and reviewing the experience of others. It may mean rectifying initial decisions with the wisdom of hindsight, for example, replacing a new accounting system with another because the initial one did not meet all requirements. In addition, externally imposed mandates and deadlines may lead to general discontent, confusion, anxiety and even unwillingness among those who are trying to implement the change.

Incremental change can take a long time, and often the reasons for change and the perceived benefits of the new system being introduced can get lost or forgotten over that time, as people leave agencies. Problems can be caused if others have taken the crash-through approach, particularly where there is a need to rely on the exchange of information and data between the two systems.

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[48] Evidence from Mr Pat Barrett, Deputy Secretary, Department of Finance, Australian Capital Territory, Joint Committee of Public Accounts: *Transcripts of Evidence - Review of Auditor-General's Reports 1993-94 Accrual Reporting (AR 32 1993-94 and AR 16 1994-95)* Volume 1, pp. 27-33.

In his evidence before the Joint Committee of Public Accounts in 1995, Mr Pat Barrett, then Deputy Secretary of the [Commonwealth] Department of Finance, indicated that the Commonwealth's approach to implementing accrual accounting was incremental, and he was critical of the 'crash-through' approach taken by NSW:

> *From the Commonwealth point of view, it was not a way in which the whole thrust of where we were coming from was conducive to: it was not the way in which we had learned from the reforms ourselves. Bear in mind that we have been in a process of reform for a lot longer than the New South Wales Government has been.*

However, in responding to questions from the Committee on the efficiency of the implementation of accrual accounting, several witnesses expressed positive responses to the implementation process in NSW.

Michael Lambert, Secretary, NSW Treasury, was positive and acknowledged that the implementation in general had been effective:

> *It is a relationship between inputs and outputs. I would have to regard Treasury inputs as very efficient. I would be more qualified with the overall efficiency for the whole sector. I do not know that efficiency is the most appropriate measure of performance. I would have thought effectiveness - what you are achieving with basic outcomes - is the ultimate test. In that regard I would give it a qualified tick. There are certain qualifications that we have put forth in our report. Generally speaking, in regard to the technical implementation for external reporting the exercise has been successful. I would be more qualified and guarded in my assessment in respect to the use of information for management purposes - the integration of information into the management decision making processes. In terms of linking to resource management I think at this stage there is a more mixed result. Some agencies, particularly those in effective management, have been much more to the fore when they have utilised systems more effectively than others. Others have tended to simply treat it as an external reporting system and have not at this stage thought through the benefits that flow from the adoption of a commercial accounting framework in their organisation.*[49]

Dr Hans Drielsma, Managing Director, State Forests and Mr Tony Harris, Auditor-General NSW, also saw the implementation as having been effective:

> *Dr Drielsma: Prior to 1991 we operated on an accrual basis for a number of years, but on an end-of-year annual basis. Since 1991 we have moved to a full accrual financial management system that has fundamentally underpinned a restructuring of the organisation and the management disciplines, and the commercial focus of the organisation. It is very much the driver for the day-to-day management of the new organisation, so it has been highly effective.*[50]

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49 Evidence to Committee, p. 63.

50 ibid. p. 21.

Mr Harris: I think it is effective because we have a reasonably sophisticated - it is still not final - fundamentally successful approach to introducing accrual accounting at the whole-of-government level and that has its own rewards, which are important. It was done in the absence of many pacesetters and it was done in a much more thorough way than I am aware of it being done anywhere else in the world.[51]

The NSW experience was not totally 'crash through'. It did contain elements of the incremental approach as well. Agencies in the Budget Sector were phased into accrual accounting in stages over a short timetable of four years.

However, the detailed submission from Treasury outlined that effects of the 'crash-through' approach were more evident at an agency level:

During the early stages of implementation, various kinds of teething problems were encountered by agencies. The more common problems were in the new accounting and financial management systems; identifying and valuing physical non-current assets; the treatment of transactions on an accrual rather than a cash basis; the maintenance of ledgers on an accrual accounting basis whilst also being required to report to Treasury on a cash GFS basis; determining liabilities for accrued recreation and long service leave; determining policies for inventory, including valuation issues; training of finance staff and accounting system operators; and ensuring operational managers and finance staff understood new systems, procedures and human resource requirements.

There were some non-technical problems as well. It is fair to say that most of the accounting and finance staff did experience a degree of pressure having to continue to perform their current duties while, at the same time, being expected to undertake the extra work associated with the implementation of accrual accounting. In the early days, there was also a certain amount of resistance to change within some agencies particularly at the lower level. Overall these issues were handled reasonably well by top management.

Another specific example of the difficulties encountered in the process is given by Mr Douglas Cook, Acting Director, Finance, Roads and Traffic Authority:

On the finance side, we had a very strong element that believed exactly what you said, that it was not worth the cost and there was doubt about whether at the end of the day we would get better decision making. The technical people, the engineers, grasped the idea. They said that for the first time our books would agree with their perception of where a project was at, because at any point in time they knew how much dirt had been delivered, how much cement had been put on the road. They had a feeling. If they were asked how much they had spent on a project and it was X dollars they would have X plus 50 per cent. But there was a reluctance on the basis that it may not have been worth going through the whole cycle.[52]

A similar view is expressed by Dr Drielsma from State Forests:

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[51] ibid. p. 73.

[52] ibid, p. 6.

I do not think there was a reluctance per se, only normal reluctance and hesitation about major change. As a result of the initiatives we took I think we had 100 per cent turnover in our finance and accounting staff within six or 12 months. So from that point of view it was fairly threatening for those people who did not have the skills to take it on board.[53]

The survey responses supported these views, and indicated that some agencies had coped well with the transition to accrual accounting:

- "extremely well";
- "positive";
- "once policies and procedures were established, staff coped well";
- "training overcame initial fear and reluctance";
- "as confidence grew, staff coped better";
- "strong support by management";
- "practical hands-on learning experience"; and
- "no disruptions and good co-operation";

However, others were less supportive and had had difficulties:

- "resistance in providing and using information due to numerous changes imposed and staff difficulties with accrual concepts. Also projects are funded by cash donations which must be reported separately and on a cash basis which has caused problems when the Department is on an accrual basis";
- "early unrealistic expectations from Treasury";
- "time taken to amend relevant legislation";
- "if guidance had been given when first adopting accrual accounting, substantial savings in time would have resulted";
- "lack of clear guidelines on some crucial issues";
- "Treasury was not proactive in developing policy - policies came too late";
- "The Financial Reporting Code failed to address major issues such as accounting for infrastructure assets";
- "Treasury failed to react quickly to the timing issues associated with the introduction of accrual accounting"; and
- "Treasury's implementation timetable was unrealistic, and demonstrated little understanding of difficulties associated with implementation".

These comments are recognised as being largely indicative of a 'crash-through' process. Treasury did not prepare a detailed plan or strategy for implementing accrual

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53 ibid. p. 30.

accounting, apart from scheduling implementation by various agencies. Thus appropriate attention was not paid to planning for possible problems, and having contingency plans and solutions ready when needed. Had Treasury undertaken better strategic planning at the beginning of the process, the impacts of the introduction of accrual accounting into agencies could have been recognised and better planned for.

In addition, if Treasury had prepared a detailed budget, actual costs could have been monitored and measured against that budget. As a result, costs could well have been lower than they turned out to be.

Summary

NSW is the only Australian jurisdiction which can produce consolidated, and audited, financial statements on an accruals basis for the whole-of-government public sector. This is the most substantial measure of the success of the implementation process.

FINDING

For some agencies the process of implementation has been less than effective. Better strategic planning, and the application of project management practices, should have been undertaken at the beginning of the process. This would have prevented or minimised many of the problems and negative feelings of agencies towards accrual accounting.

5.9.1.3 Cost Effectiveness

The Committee has experienced difficulty in arriving at an actual cost of implementing accrual accounting in the Budget Sector.

Mr Tony Harris, Auditor-General for NSW, provided his thoughts on the dollar cost of the implementation:

Mr Harris: Last year I gave a speech, unboxed as usual, which estimated the cost of introducing accrual accounting in New South Wales to be about $100 million.

The Committee: You say $100 million, Treasury says $60 million, the Department of Health says about $50 million.

Mr Harris: I am on the Department of Health's side, but $50 million is a lot of money for the Department of Health. The Education Department would not have said it cost that much, but it has not finished accrual accounting yet.

The Committee: Forestry says it did it internally, but there is still a cost.

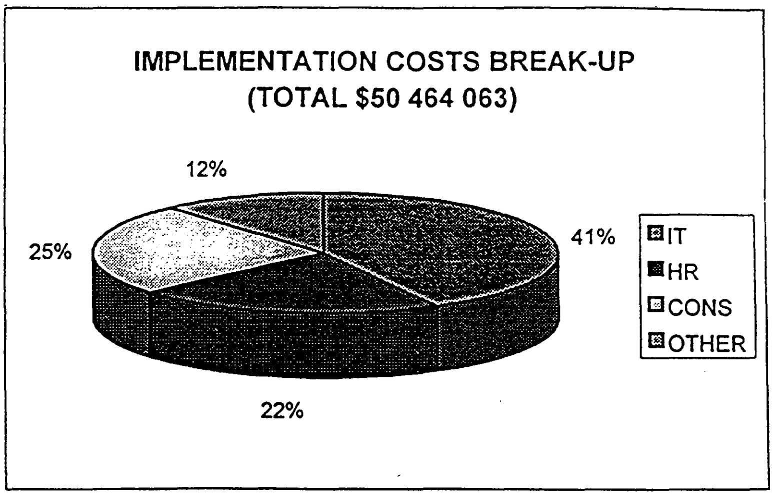
Mr Harris: Forestry has not finished yet, but there is still a cost, yes.

The Committee: I still cannot understand why the estimates vary so much.

Mr Harris: I am not in the Government so I do not have the kind of access to data that they have. I was just looking at what Treasury provided and what various agencies said it cost, but I did not have the $50 million for the Department of Health. I might have jumped it up a bit, but I would be surprised if it did not cost around $100 million to introduce. It is not finished. As I said the Education Department is not finished and State Forests is not finished.[54]

The Committee's survey results are inconclusive on this matter. Out of 45 agencies, 35 supplied cost data. Of these, 48% (17 agencies) gave quantified costs totalling $15.66 million and the other 18 agencies gave estimated costs of $36.53 million. The total costs identified by agencies as being attributable to the implementation of accrual accounting were $52.19 million. The costs ranged from a quantified cost of $8.7 million for the Department of School Education, to an estimated cost of $20 million for the Department of Tertiary and Further Education (TAFE)[55].

The chart below indicates the total of these costs broken down into several major components[56].



[54] ibid. pp. 77-8.

[55] In relation to the latter estimate, the amount should be viewed with caution, given that TAFE has undergone numerous changes in the period 1990 to 1994, and a significant portion of the estimated costs could be attributed to other factors than the costs of implementing accrual accounting.

[56] Some agencies provided a total cost only and did not break down costs into components requested in the survey. This explains the difference between the total costs quoted in the general text, ($52.19 million) and those used in the chart ($50.46 million).

The majority of costs incurred by agencies was in acquiring new information technology. This is probably because previous accounting systems were too simple to capture accrual information and had to be upgraded or replaced to meet new requirements. These requirements demand that information systems have the capacity to capture, process and report greater volumes of complex information and data. In contrast, costs associated with human resources (e.g. training, seminars, additional staff) and the engagement of consultants were relatively similar (22% and 25% respectively).

The Committee recognises that the total cost of $52.19 million collated from the survey data is not likely to represent the true dollar cost of the implementation process. Many agencies said they had not kept specific data on dollar costs directly attributable to the introduction of accrual accounting, and they were unable to provide accurate quantified or even estimated costs of the process. If the estimates given by the Department of Health ($45 to $50 million) and Forestries ($1million on valuation processes only) before the Committee during the inquiry proceedings were added to the cost data supplied in the survey responses, the Committee believes the conservative estimate of costs is likely to be closer to, if not more than, the Auditor-General's estimate of $100 million.

Agencies also indicated that there are a number of on-going costs associated with accrual accounting:

- "ongoing maintenance of hardware and software";
- "additional accounting costs associated with running dual systems [cash and accrual]";
- "investment in training is substantial and must be updated regularly or replaced as staff turn over";
- "license fees for software, upgrade costs for software";
- "costs for valuation of assets - revaluation costs may occur every 3 years depending on financial outcome of revised accounting standards";
- "additional costs on a monthly basis in determining and bringing to account accruals and prepayments";
- "disbenefits such as increased complexity of accounting system and reporting with subsequent impact on time of staff operating systems;
- "ongoing costs to provide training or instruction for system enhancements and changes in accounting policy"; and
- "additional costs to produce a myriad of different accounting reports e.g. reports required by different areas of Treasury e.g. Budget Sector Division and Accounting and Finance Division receive separate similar year end reports".

Summary

The Committee concludes that it is likely that the true dollar cost of the implementation of accrual accounting will never be known. Records within agencies are at best very sketchy, and at this point in time, the costs of implementing accrual accounting at both agency level and overall for the Budget Sector are likely to have been amalgamated with other 'normal' operating expenses. Consequently, they are difficult to quantify, and in the majority of cases, identify.

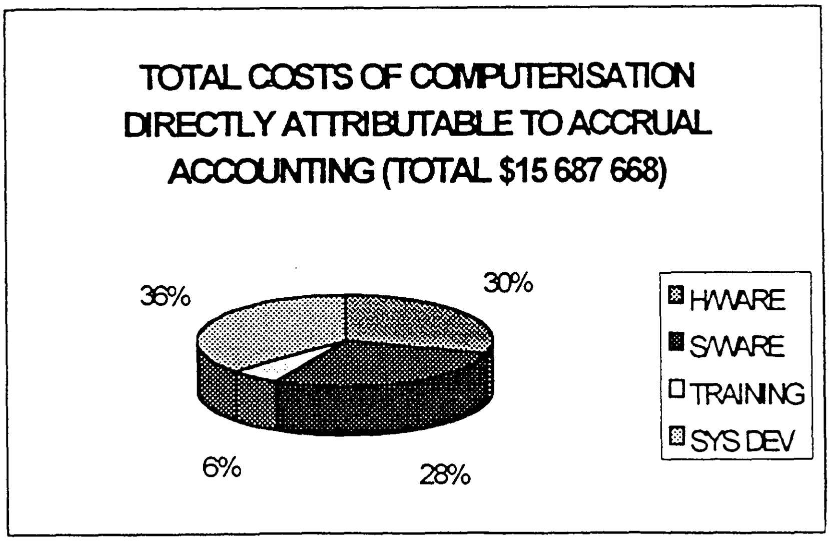
If Treasury had required agencies to separate out the costs of implementing accrual accounting, and if it had paid sufficient attention to managing the implementation process under the accepted principles and practices of project management, the performance measures and indicators of success in terms of costs/benefits would have been more readily available and able to be quantified.

5.9.2 Are the computerised systems introduced for the purposes of accrual accounting adequate, and do they integrate into a total management system?

5.9.2.1 New Systems

The response to this question is indicative of major change which often requires significant technological overhaul in order to cope with the more complex demands of a new approach to recording and reporting operational activities and performance. The survey information received indicates that 62% of those agencies responding purchased computer equipment when they introduced accrual accounting during the implementation phase (1990 - 1992).

The Committee asked respondents to break down their computerisation costs, directly attributable to the implementation of accrual accounting into major areas and components. The total computerisation costs submitted by respondents ($15,687,668) is shown in the chart below.



5.9.2.2 Integration and progress towards Total Management Systems

Some agencies have progressed further towards total management systems and integration of systems than others. For example, State Forests appears to have a sufficiently integrated system to allow production of accrual information which is then used for management purposes. This example is provided by Mr Dominic Staun, General Manager, Corporate Services, State Forests:

> *We have monthly accrual accounting and reporting by 106 responsibility centres, by activities, jobs, resources and products. We have a very comprehensive information system and it is also linked up to the whole planning and reporting system. We have a corporate plan and three-year business plans which are financial projections tied to that corporate plan, and they set the scene for an annual budget which is prepared from the ground up. That is monitored and managed on a monthly basis along with cash and capital expenditure. We reforecast at the end of the financial year so that we know where we are going, so that if our revenue is not keeping up we can take action to fix it. It is also tied in to our quarterly GTE reporting to Treasury and executive reporting. It is a very comprehensive and integrated system which drives the organisation on a bottom-line basis.*[57]

Of the 25% of agencies who indicated that their systems did not meet their needs, reasons varied:

- "systems still to be perfected from a reporting point of view";
- "new financial management system is being developed for implementation in July 1996. Current systems do not capture all debt information but systems are being developed to capture this information";
- "modifications and enhancements are required to allow compliance with changing external reporting requirements and to ensure emerging user needs are satisfied";
- "further modifications have been necessary to accommodate capitalisation policy guidelines issued by Treasury in January 1994. Systems fall far short of needs as they are not integrated, are slow and inefficient, uneconomic to maintain and/or upgrade further";
- "existing accounting system was modified in-house and while it satisfies all audit requirements it does not fulfil all management requirements"; and
- "initial software implemented was called 'Maximise'. It has since been replaced with the new 'Sun Systems' purchased under the GSAS-FMS NSW government contract arrangements".

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[57] ibid. p. 29.

The evidence suggests that although the implementation phase has been significantly concluded by the majority of agencies, there continues to be a high level of internal activity in enhancing and improving these systems to enable better capture reporting of accrual accounting information to meet user needs. Agencies are on a 'learning curve' in respect to accrual accounting and are at various stages of integrating systems to provide suitable outputs and reports for use.

In its 1994 submission to the Committee, Treasury acknowledged that agencies were at various stages of integrating general ledger systems with other financial management modules. Also, the comments of Mr Michael Lambert, Secretary NSW Treasury, earlier in this Chapter on the effectiveness of the implementation, indicate that some agencies have had greater success in the integration of their systems than others.

Summary

Although evidence suggests a positive trend forward in respect of the adequacy of accounting systems, and their integration into systems which provide total management information, each agency's progress, to date and in the future, is dependent on its size and to the commitment and understanding of its management.

5.9.3 To what extent are senior executives of agencies using accrual information for management purposes, including costing and monitoring of outputs and inputs?

5.9.3.1 Benefits and extent of use of accrual information

Analysis of the survey information received suggests that the use of accrual accounting and the production of accrual information appear to have produced eight main benefits for agencies:

- the ability to disclose a truer cost of services provided;
- an improved focus on operational results;
- the ability to measure and monitor agency performance;
- the ability to identify and disclose previously 'hidden' costs;
- an improved level of decision-making and forward planning;
- the ability to identify, record and disclose assets;
- greater efficiency in resource management and allocation; and
- the use and adherance to accounting standards.

Agencies believe that their decision-making capabilities have improved, along with the ability to provide more comprehensive financial management information and data. Agencies believe they are now more able to monitor the true position of assets and liabilities, spread expenditures more evenly over the accounting period, and present a truer picture of the actual costs of producing products and services.

A number of comments also indicated that accrual accounting has halted the 'spend it or lose it' mentality that existed under the cash system where agencies would undertake a high level of purchasing activity towards the end of the financial year to use unexpended portions of their appropriations, rather than losing them back to the general consolidated fund. Because of the ability to disclose the truer costs of services and thereby better manage projects and resource allocation, agencies can present information to substantiate, increase or maintain their level of appropriation from one financial period to the next.

A good example of the benefits of accrual accounting really making a difference and changing decision-making comes from State Forests, from Dr Hans Drielsma, Managing Director, and Mr Dominic Staun, General Manager, Corporate Services:

> *Dr Drielsma: One [example] would be a recent look at our workshop operations and at our aircraft operations. We have been able to come to sound decisions based on accrual accounting information and our ability to project that forward to come to sound decisions about the likely performance of those assets and whether we should maintain them or dispose of them. In the current circumstances we are undergoing major change in the landscape in terms of future supply sources. For instance, in native forests we are getting a lot of assessments and there will be a lot of change in the assets we will have access to in native forests. We have been able to project that forward and make decisions about structure, offices and those sorts of things that we will be able to sustain into the future. We will be better able to do that much more effectively with the information systems we have got than we had five years ago.*

> *Mr Staun: A good example is our workshops. The original structure was that each workshop was located in a region and reported to a region. Because they were not separately identified as individual profit centres, the total cost of that operation got lost and was never seen. We set it up as a separate operation, with a separate manager running it, on an arms-length basis with the regions. Within three years, from an administrative loss in my view of about $1 million a year, with 130 staff, we now run 70 staff and make about $1 million a year, with a 20 per cent return on profit. That is the sort of decision-making in action that can be driven by a good clear-thinking commercial philosophy and a good information system to support it.*[58]

A further example comes from Mr Douglas Cook, Roads and Traffic Authority:

> *I was in the RTA in 1986-87 before accrual accounting was introduced in 1988-89. At that time we were managing purely on cash. It was almost impossible to avoid major problems because of details of expenditure coming in from all over the State and only being brought to management's attention when it hit the ledger. We had extreme difficulties. Introduction of accrual accounting has enabled management to manage throughout the year. We fully use the accrual method. We*

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[58] ibid. p. 31.

method. We require our regions and zones to advise expected expenditure within five working days of the end of the month and we make decisions on that. At that time our central Ashfield depot and central store were commercial-type operations and we were never confident that they had their full costs of operation prior to accrual accounting.

From a financial viewpoint [a return to cash accounting] would be a return to the Dark Ages because of the size of the organisation and the amount of major works that have been done by contracting councils. It is very much a matter of bringing all that information together by the accrual method. The engineers always told us that they understood how much they spent, but the accountants were giving a different figure. They worked on the basis that we had a set of books and they had a set of real books out in the field. Now we have the one.

I believe [accrual accounting] has been a tremendous investment for the authority because we now can manage where we are at any point in time. There is no need for us to be sort of sitting on cash because vouchers might be coming in from all over the State. We know whether vouchers are coming in, we know when they are due for payment and the systems we have set up are automatic as far as loading in the data payments for vouchers. So we can look at any point in the future and say how much cash we are up for and when the cash is required to be drawn down.[59]

Another positive example from Mr Peter Cunningham, Valuer-General, shows that agency management has found accrual information useful for determining the true costs of services :

It has certainly been particularly useful to establish the full costs of the operations of our organisation. In recent years we have been required to operate on a commercial basis, and in developing the actual costs of our services for all our clients, but particularly for the Office of State Revenue and for 177 councils throughout the State, accrual accounting has given us a handle on the full costs of our operations. As our organisation moves towards commercialisation when we will be subjected to competition from the private sector, again accrual accounting has given us the full costs and understanding of the actual costs of our operations. No doubt we will give clients the benefit of that in due course.[60]

Mr Ken Barker, Department of Health, provided a further example which again reflects management's ability under accrual accounting to determine the costs associated with particular services:

I think we are [getting value for money] in that we have a much better idea where we are spending our money and we are going to have to use it when we move into what we call casemix costing. We will use Oracle to feed into that. We need a good idea of where our costs are and where our staff are to have an idea of casemix costs. At present we do modelling to come up with the figures. A person may go into a hospital for a hernia operation. We can identify the average cost of that operation as opposed to a heart bypass operation. It will have a different cost structure. We can compare the different costs. Under the economic reforms that were announced by the government we want to benchmark different hospital costs to see the differences and then have managers understand why there

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59 ibid. pp. 4-5.
60 ibid. p. 31.

are differences in the cost buckets, which will be in areas such as nursing staff, medical costs, drugs, support services and allied health. So you need to know not only your total cost but some of the buckets that feed into it, and you need a good accounting system to support that.[61]

FINDING

Accrual accounting enabled management to shift their focus to operating results and the financial position of the agency, rather than simply looking at the spending of cash against allocated funds. This means that managers at all levels are now more aware of the true financial and operational results of their areas, and therefore are more cognisant of the need to better plan and allocate resources. Decisions on resource requirements are more likely to reflect actual requirements rather than rough estimations, and as a result of the broader understanding of the myriad of financial implications each decision has, there is more focus and attention on achieving a higher level and quality of service.

This point was reiterated by Mr Dominic Staun, State Forests:

One of the reasons for the Government wishing to move to accrual accounting and to putting market values in the balance sheet is to derive better decision making within the public sector and also so that people within the head office of the public sector in New South Wales and shareholders can get a better idea of whether those assets are being utilised properly.

I will give you an example. If you run a corner newsagency you might have the value of that newsagency, because you have been running it for 10 or 20 years, in your books at $3,000, but you know intuitively that it is worth $300,000. You are not going to worry about changing your books from $3,000 to $300,000 because you know internally you are making the decisions and you will not sell it for $3,000 if you are looking for at least $300,000. But if you are a large company or in the public sector and that value is in the books at $3,000 you might not know that it is actually worth $300,000 and therefore managers, or indeed decision makers or shareholders outside the organisation, might be making decisions on the wrong basis. They are not taking the true cost into account. I can see the value of the thinking behind the exercise. The extent to which the exercise has been driven and the final outcome is something that others will have to make judgements about in their own particular areas.[62]

A significant number of respondents indicated that, for the first time, they were able to identify and record assets, and that they had obtained better control of fixed assets. This has led to the implementation of asset and property management strategies. Agencies are now able to fully comprehend the concept of depreciation and the need to implement and internally fund maintenance programs. As well as depreciation and maintenance, other 'intangible' and previously 'hidden' costs such as employee

61 ibid. pp. 4-5.
62 ibid. p. 35-6.

entitlements (superannuation, long service leave) are now being disclosed for the first time, requiring agencies to consider plans and strategies for funding these costs in the anticipation of future payouts and replacements (of assets).

There also appears to be an appreciation by agencies that they are now able to operate in a similar manner to private sector entities, and that this ability puts them in a better position to compete commercially if and when the need arises. Staff are also able to use skills and knowledge gained in tertiary education and/or experiences outside of the public sector, as accounting practices now align closely with the theory, concepts and practical applications being taught in tertiary institutions and used in corporate entities. This has enabled agencies to recruit from a wider pool of prospective employees and thus increase the accounting and finance skills base both at the agency level and across the public sector generally.

Agency comments indicated that many are now becoming interested in their increasing ability to compare and benchmark their own performance with other similar service industries. The use of accrual information for formulating performance indicators and monitoring performance, in general, is encouraging. The Committee has noted this previously in its report into annual reporting in the NSW public sector.[63]

5.9.3.2 Level of cash information kept, required and/or used

Anecdotal evidence provided to the Committee, and preceding the Committee's survey, suggested that agencies continued to maintain both their previous cash based systems and their new accrual accounting systems. The Committee was concerned that such practices indicated both inefficiency and an insufficient commitment to accrual accounting in general. This led to agencies being questioned in the Committee's survey as to whether they maintained previous cash-based systems in addition to their accrual systems. Responses received indicated that 84% did not maintain 'dual systems'.

However, the evidence before the Committee indicates that cash systems appear to be maintained, firstly, to enable reporting back to Treasury against appropriations and budgets (still in cash) and, secondly, for internal reporting purposes. Some agencies also continue to maintain cash systems for reporting back to the Commonwealth, particularly where large amounts of money are received from Commonwealth funding.

The Committee's views are further supported by a specific example given by Mr Ken Barker, NSW Department of Health:

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[63] Public Accounts Committee - *The Truth, the whole truth and nothing but the truth? - Annual Reporting in the NSW Public Sector.* Report No. 5/51 [No. 95] March 1996.

As an inner budget department we are still very strongly aligned to the Treasury's focus on net budget impact, which is traditionally cash focused. Internally we have tried to increase emphasis on accrual accounting, and that certainly has happened. But in terms of reporting to Treasury, Treasury still is dominated by the cash results of our performance and how that impacts the State deficit as the State budget is indicating. There is the conflict that the principal financial master wants you to report on a cash-based approach and judges you on how you perform against that budget, yet we also have to go through the process of accrual accounting. We are trying to use accrual accounting within our organisation for various decision-making purposes, but for external reporting to Treasury cash is the main focus of their direction.

There is a very complicated set of monthly reports which have some accrual information but for this current year the key items of focus are current payments, current receipts, capital payments, capital type of receipts, which then gives net budget impact, which is geared to the State deficit. There is a net budget impact and we have to advise on how things are moving and that is all cash focused.[64]

Recurring comments from survey respondents related to Treasury's requirement for cash information, the need to produce cash information for reconciliations to internal and external budgets, for government recurrent and capital budgets, and appropriations:

- "reasonably often, as state recurrent and capital budget is still appropriated in cash".
- "major focus of financial management reports is cash based because the budget is cash-based";
- "the Department receives funding from the Commonwealth and receives it on a cash basis and is cash based. Reporting back to the Commonwealth requires cash based information";
- "cash based reports required regularly to meet reporting requirements of Commonwealth funded programs";
- "mainly for research grants where donor bodies still account on cash basis";
- "minimum monthly [reports] because of Treasury monthly reporting but also at key projection times"; and
- "monthly [reports] to monitor the extent of expenditure related to government recurrent and capital budgets".

In discussing the initial problems which confronted her as a new Chief Executive Officer, particularly in the Health Services, Dr Diana Horvath, Chief Executive Officer, Central Sydney Area Health Service, provides a particularly insightful explanation supporting the earlier comments from Mr Ken Barker, Department of

[64] Evidence to Committee, p. 33.

Health. Her comments supported many of those received in the survey on the need to produce cash information, even after the implementation of accrual accounting:

As a result of that experience, it was agreed very early on with our Board of Directors that cash is king and that we should continue to report to them on a cash basis. We have continued to report to them on those terms to this day. But don't conclude that we take no notice of the impact of the accrual side of our business. We do. We are very conscious that accrual will become of absolutely vital importance in the near future.

Though we report to and base our narrative to the Finance Committee of the board in cash terms, we also supply them with the official monthly report to the Department of Health. That report not only measures the year to date figures in accrual terms but also demands a projection of the full year result. Where a deficit is anticipated, it seeks an explanation and a plan to address a negative projection. In-house reports to the general managers of our facilities are reported in both accrual and modified cash so that they are aware of both sides of the same coin.[65]

FINDING

The Committee believes that there is sufficient evidence to suggest that agencies continue to maintain separate internal cash information systems - which may or may not integrate with their 'accrual' systems. This is to satisfy internal reporting requirements to management; to meet Treasury's continuing requests for cash information; to permit supply of Government Finance Statistics to the Australian Bureau of Statistics; and to allow Treasury to monitor agency performance against cash budgets and appropriations.

In their submission to the Committee, Treasury acknowledged this problem of requiring cash information and some agencies' general concerns:

Agencies generally have expressed concern at the continuing emphasis being given by Treasury to the cash based information on their finances. The agencies' concern appears to be two-fold. Firstly, the cash basis of appropriations has led to situations where an agency may be 'on track' in accrual terms but under or over Budget in appropriation terms. (The converse could also be possible). Some agencies have claimed that this has created confusion among Budget Sector managers. As indicated earlier in this submission, both appropriation targets and accrual targets are equally important in the monitoring of the performance of an agency by the Treasury and the internal managers.

Secondly, there is a concern at the level of information which has to be prepared and submitted to Treasury to enable the cash-based GFS (Government Finance Statistics) budget results and projections to be compiled. While much of this information would be fairly readily

65 *A Chief Executive Officer's View* by Dr Diana Horvarth, CEO, Central Sydney Area Health Service - PAC Seminar on Asset Valuation in the Public Sector, 16 February 1996. Report No 6/51 [No 96] April 1996 pp 110 - 111.

available to the agency, some of it will clearly involve additional analysis or estimation (for example the cash basis of measuring current and capital outlays requires an estimation of the components of accounts payable which relate to operating expenses and asset expenditure).

The focus of Treasury's analysis and control is increasingly moving to the net cost of services (an accrual measure). However, there is still a need to closely monitor the GFS position and the impact of agency operations on the approved level of Consolidated Fund support. This will inevitably mean a continuing need to collect data not normally required by agencies to produce the standard financial statements and to provide associated explanations of changes in the various Budget aggregates.

The Treasury is currently developing a new Financial Analysis System under which data collection will be more closely aligned to the structure of the standard financial statements. GFS reports will be produced by the Treasury based on information derived from the data collected from agencies. Apart from making the supply of data easier for agencies, this will also give Treasury much better information for analysing agencies' financial position in terms of the standard financial ratios, etc as applied in the private sector (to the extent they are meaningful in the public sector).

Mr Michael Lambert, Secretary, NSW Treasury, also commented separately in evidence before the Committee on the subject of Treasury's focus on collecting cash information:

We require information regularly on both a cash and accrual basis. We monitor both the cash and accrual position. In Budget Paper No. 3 you will see we start from an operating statement which is on an accrual basis and then we reconcile to the cash appropriation of the agency. Therefore, we are interested in both measures. What has primacy? I suppose, strictly speaking, it is cash because of the method of appropriation. As I said before, we monitor both and regard both as target requirements.[66]

We obtain information on operating statements which are on an accrual basis. We then require adjustments to reconcile back to a cash position for the agency. So although we measure the components of expenditure on an expense basis, we then measure the overall capital and current outlays of the organisation by making adjustments for non-cash items.

The main benefit that we would see from an agency point of view is in terms of use of the framework for more effective resource management. Prior to the implementation of accrual accounting we reported at a whole-of-Government level on an accrual basis - that is, a balance sheet and operating statement. I must admit that it was an estimate. It was not based on the detailed accounting reports of agencies; it was based on some adjustments to a cash basis so there were a lot of approximations. Certainly, we were providing crude but reasonable estimates at a whole-of-Government level.

External reporting on a monthly statement is a cash-based statement. The information that the ABS collected to date has been cash based. A lot of the external reporting is in fact cash-based. The fundamental rationale for conversion is to improve the internal resource management for agencies. It has another benefit in that it refines and improves our external reporting on a whole-of-Government basis. So the degree to which there are some deficiencies

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66 Evidence to Committee, p. 63.

in the application of accrual accounting agencies to resource management is a disappointment to us, and it is our focus in trying to go forward on a strategy to improve performance in that regard.[67]

FINDING

The Committee recognises the need for Treasury to continue with cash reconciliations to monitor performance against cash appropriations, and acknowledges this as the likely legacy of the speed with which NSW has undertaken its implementation of accrual accounting. This has left the Commonwealth and other government and non-government bodies in other jurisdictions in its wake and having to play 'catch-up' accounting.

As the Committee understands it, the present practice is not to table before Parliament the consolidated, whole-of-government financial statements which are produced by Treasury from all the information gathered from agency accrual data. This may be also indirectly contributing to agency concerns about cash information being Treasury's main focus. Agencies may feel that the Parliament is not fully aware of the benefits of accrual information given that Parliament's appropriations are still made on a cash basis. The Parliament therefore does not use accrual accounting in making resourcing decisions and plans for government services and programs. Agencies may see this as a reason why they should not undertake to use it internally.

The extent of use of accrual information in agencies is probably best summed up by Mr Tony Harris, Auditor-General for NSW:

If accrual accounting is to have any meaning at the entity level, it has to be used at the entity level. We have seen good examples where it is used at the entity level and we see many examples where accrual-based information is not used. Because it is not used it is irrelevant to the financial systems, so that is the first step. I have some sympathy for agencies not using accrual-based information if other drivers are more important, and at the moment cash is the driver. So I have some sympathy about why they are hesitant about going down the path when nobody seems to be valuing it. But nevertheless even for internal management purposes accrual accounting ought to be used even if cash, in other circumstances, is a driver. While I am sympathetic, that does not override my disappointment.[68]

Summary

The Committee concludes that the continuing practice of funding agencies through cash-based appropriations appears to be perpetuating agencies' views that Treasury

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[67] ibid. p. 66.

[68] ibid. p. 77.

considers cash information to be superior. It also appears to be hindering a more complete acceptance and (internal) use of accrual information.

RECOMMENDATION

While the external reporting of accrual information by agencies appears to have risen since initial implementation, it is considered that the internal use of such information would be significantly higher if:

- external Parliamentary budgets and appropriations were made under the accrual concept of accounting; and
- the end product of the whole process - the consolidated whole-of-government financial statements, together with the audit opinion on those statements from the Auditor-General, were tabled in Parliament.

5.9.4 Has sufficient training been provided to both financial and non-financial staff, and do financial managers possess an appropriate level of skills and competencies to provide financial management and advice?

5.9.4.1 Training

The following comments were made by Treasury in their submission to the Committee:

Apart from the training, assistance and advice provided centrally by the Treasury, the agencies themselves have each put in place their own measures to meet the re-skilling and educational requirements arising from the implementation of accrual accounting. The measures adopted include on-the-job training, attendance at internal/external courses, the issue of policy and procedure manuals and the establishment of internal support mechanisms (eg networking and discussion forums etc.) In those cases where the agencies have employed consultants, efforts have been made to secure a transfer of knowledge to the finance staff with varying degrees of success.

In addition, Treasury gave the Committee details of the training provided for the various levels of staff within organisations and the types of training for both accounting and non-accounting personnel. The Committee is satisfied that the type of training offered and provided by Treasury was, and is, sufficient to ensure that agency staff had at least a basic understanding of the concepts, theory and application of accrual accounting.

In relation to the Committee's own survey, and apart from training costs, close to half the survey respondents supported this view, indicating that Treasury had organised training in accrual accounting concepts for them. Only 6% of respondents indicated that the training was compulsory. The majority also stated that this training was not on-going, with most agreeing that it was not necessary for training to continue as Treasury and other experts were usually available at all times, on a needs basis, to answer specific questions and resolve issues.

However, it is difficult to reconcile these comments with a number of other comments made by respondents to other survey questions, particularly in relation to the use of cash information and receiving value for money from using the accrual accounting concept. A number of these responses indicated that:

- some groups of end users still do not understand the concept of accrual accounting;
- some levels of management ask for information to be converted back to cash because they don't understand the principles of accrual accounting;
- because the agency is not profit motivated, there were no benefits from accrual accounting; and
- because Treasury's ultimate concern was cash receipts and payments, there was a tendency to concentrate on cash reporting.

As these types of comments have appeared consistently in the analysis of the survey data, the Committee is not convinced that sufficient emphasis was attached to the benefits of information sessions and training courses and seminars offered by Treasury. Whilst training was generally considered appropriate, it is apparent that attendance was voluntary and that agencies were left to decide how many and at what grades and classifications of staff should attend.

Summary

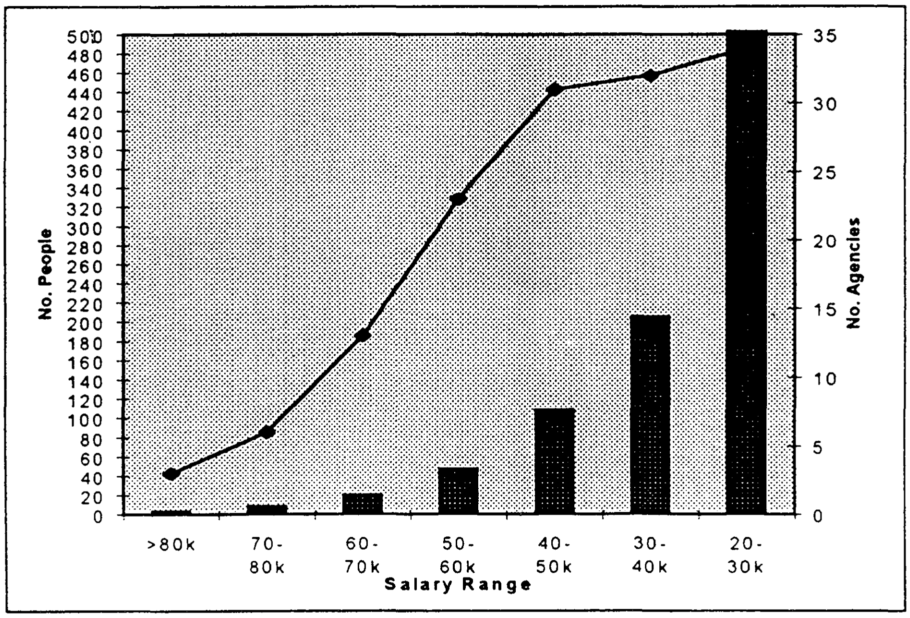
The training offered by Treasury was sufficient in content to ensure that, at an agency level, the basic concepts, theories and application of accrual accounting by accounting and non-accounting staff could be understood and communicated.

However, had training been mandatory for all staff in Budget Sector agencies, current negative views on accrual accounting could have been minimised and better dealt with in the initial stages. It may also have ensured the reasons for implementation of accrual accounting were better communicated to agency staff, ensuring all staff involved had a proper level of understanding of why the change was being undertaken and how that would affect the agency.

5.9.4.2 Skills and Competencies

In general, respondents to the Committee's survey indicated that staffing arrangements did not change considerably as a result of the introduction of accrual accounting. Two specific comments indicated that all financial/accounting staff employed at the time of the implementation of accrual accounting had since left, or that all staff in that area were new to the agency since 1990.

For most other respondents, staffing levels have remained constant, with only a small number of agencies employing a total of 91 additional staff after the change process commenced. From the graph below, it can be seen that the majority of finance/accounting staff in agencies are at the lower end of the range of salary levels.



Out of the 45 agencies responding:

- 69% had a total of 109 people at the $40,000 - $50,000 range;
- 71% had a total of 206 people at the $30,000 - $40,000 range; and
- 75% had a total of 512 people at the $20,000 - $30,000 range.

Of the 91 additional staff employed after the change to accrual accounting, 1 person was employed at the $70,000 - $80,000 range, 10 at the $60,000 - $70,000 range, 6 at the $50,000 - $60,000 range, 43 people at the $40,000 - $50,000 range, 22 people at the $30,000 - $40,000 range, and 9 people at a salary level below $30,000.

Survey data indicates that 73% of respondent agencies spent between $2,375 and $1, 425,000 on the engagement of consultants, totalling $12,130,457. This is more than double the total dollars consumed on training ($4,888,430), even though a greater percentage of respondent agencies (80%) indicated that they had incurred training costs.

It is apparent that agencies chose strategies other than permanently increasing staffing levels to accommodate the change to accrual accounting. It is likely that these strategies were confined to re-training of current staff in the new techniques, and/or temporary increases in the use of consultants to handle the changes required.

It is difficult to draw specific or accurate conclusions from the data supplied, particularly as any number of internal and external pressures and factors can impact on staffing arrangements within agencies.

General Observations

The staffing profile from the survey revealed that agencies tend to have greater numbers of people at lower classifications and grades. Some observers may construe this as being indicative of a lower level of skills and competency, though this is not necessarily the case. Evidence suggests that, depending on the individual agency's commitment and resourcing ability, the change to accrual accounting has had varying impacts in respect of increasing or changing staff competencies and skills.

An example from Mr Ken Barker, Department of Health:

> *Finance - I will use the word "finance" in its broadest definition - includes accounting people, people who do accounts payable, revenue clerks, all those people. A lot of them had only ever been in a cash environment. We had to undergo extensive training and educational programs on what commitments means, what to do with a requisition when there is a sundry creditors arrangement, when revenue has to be brought to account and all those types of things. We had to undergo a range of internal training, and it was left to each entity to do its own training.*
>
> *It has meant a change for finance-type people, those who do more analytical work than basic accounting work. They have to understand the principles, if they have been long out of any form of tertiary study, because debits and credits and all that were not very well understood in a pure cash environment. So there has been an education process. It gets a little confusing when Treasury still comes back to us and wants to focus on net budget impact and cash-only items. That is when people start to be critical of why we have gone down here when we are*

still focussing over here. I still have the view that the accrual accounting reforms will be to Health's benefit in the long run if we can solve a couple of the issues that I raised earlier.[69]

Other agencies, like the Audit Office and the Roads and Traffic Authority, did not require significant change in order to accommodate the implementation of accrual accounting:

Mr Harris: Interestingly, no, because the training that [Audit Office staff] received was accrual based, so when they left the accrual based training to audit a department they had to actually junk some training because it was cash-based. Also, we had a large number of audit clients who were accrual accounting - the government trading enterprises - and our staff would have had exposure to those as they were cycled around the audits, so I think we would have found it reasonably easier than you might think.[70]

Mr Cook: If I could talk about the training of [Roads and Traffic Authority] staff initially, at the introduction of accrual accounting in New South Wales we were working with Austroads, the old NASRA-all Australian road authorities. There was a project in Western Australia utilising Arthur Andersen and Company. I went over there for about a week. I worked through with their contractors as to how they were implementing it, what their implementation plan was and what their training approach was. We then introduced a similar situation here. We believed we had the staff at the time to implement accrual accounting. It was what most of the younger people had trained in anyway. They were well aware of the current methodologies. At various times we got some additional assistance but only as hands on. When we set up our asset registers it was such a messy job that we pulled in a couple of contract people, but not consultants, merely as arms and legs. We believed at the time that was the way to handle it. We were quite convinced that if we brought in people from outside we would always have the problem that when they went they would take the knowledge with them and we would be left to sell the message. We were also aware that we had to sell the message and we had to show commitment and ownership to accrual accounting. We thought that if we brought in outside people and said 'Here is accrual accounting. Trust me, it is the best thing for you', and then the consultant contractors walked we would be left to make it happen and to make it work. So it was a conscious decision that we were there from the start right through.

During the initial phase a couple of times contract accountants were brought in as arms and legs to help establish the asset registers. I think it is fair to say that within the authority we have increased our expertise and the number of qualified accountants since the introduction of accrual accounting. But I see that more as increasing our financial management rather than as a by-product of accrual accounting. Until the late 1980's we did not have any financial accounting outside Sydney. We had a centralised accounting area - this was back in the cash days - providing reports at a management level. As part of the implementation of accrual accounting to get that information out - I think it was more to get better financial management in the field - we established a number of accountants in the zones and regions. We have more financial people now than we had in 1987 but we have immeasurably better financial information than we had then.[71]

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69 ibid. p. 41.

70 ibid. p. 79.

71 ibid. p. 7.

Whilst the Committee has received no direct evidence, either through its hearings or its survey, to suggest that agencies are still insufficiently trained in the theory and application of accrual accounting, it has previously been indicated to the Committee that agencies appear to have been left to make their own decisions as to whether to accept the training offered.

Comments such as those from the Auditor-General at the Public Accounts Committee's Seminar on Accrual Accounting do raise some concerns about the level of accounting skills within agencies, particularly as noted, in smaller agencies:

> *From the audit point of view, what are we seeing in front of us? We are certainly seeing those issues which I spoke about already, those problems or challenges, as they are better described, that we are facing. We are also seeing still that we are more inclined to be accounting advisers than as auditors we ought to be. This is not so much so for the larger organisations, but for the smaller organisations. We tend to get a series of accounts which improve through our auditing techniques. We say, no that figure is wrong, it should be this figure. We will cross out that figure and we will put in the audited figure. We tend to build up their set of accounts from our auditing practice, rather than we auditing their set of accounts.*[72]

Some agencies may still be relying too heavily on external bodies such as the Audit Office and Treasury, at the expense of further training and developing their own staff to more adequately cope with the requirements of accrual accounting and reporting. If this is so, then the Committee has concerns as to whether agencies are getting the full benefits from accrual accounting and reporting, including that of adequate internal points of reference and advice, despite respondents' generally positive comments to Committee questions in this respect.

Skills and competencies should be further enhanced, particularly in the development of competency standards, which may assist in ensuring that the public sector maintains a high level of quality finance and accounting staff. One proposal has been suggested by the NSW Treasury in their submission:

> *In order to fully maximise the benefits of the accrual accounting system, the Treasury believes that agencies should take further action to ensure that there is a high level of accounting and financial management expertise in-house; that support staff are properly trained and that managers possess the knowledge/understanding of the issues involved and the 'know how' in terms of using the information generated for strategic and operational decision making.*
>
> *Budget Sector accountants generally were competent in terms of the previous cash-based accounting and reporting requirements. However the financial reforms have highlighted a need to extend their knowledge and expertise in relation to the whole area of accrual accounting and financial management. In addition, they must also possess a high level of analytical problem-solving, communication and organisational skills.*

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[72] Public Accounts Committee - *Proceedings of the Seminar on Accrual Accounting - The Scorecard to Date 13 December 1994.* Report No. 89 February 1995 p. 56.

> *The new reforms, with a focus on performance, accountability and the devolution of financial management responsibility, have now placed a much greater demand on the skills of finance managers to an extent not seen before in the NSW Budget Sector. In effect, there has been a quantum shift in the role of accountants from being 'number crunchers' to being consultants and advisors, analysing and interpreting information, giving expert advice on financial and related resource management matters and establishing sophisticated accounting/budgetary systems.*

This is further supported by recurring comments made in response to the Committee's survey which indicate that there is still a requirement to supply agencies with additional training and information on accrual accounting. In addition, Treasury's submission also included a substantial discussion on the need to develop competency standards to be applied to all public sector accounting and finance positions.

Summary

Sufficient training in the concepts and application of accrual accounting has been offered by Treasury and accepted by agencies, for both accounting and non-accounting staff. However, communication of the underlying reasons for the change and a greater acceptance of the accruals concept could have been obtained if Treasury and all agencies had made training compulsory for all staff.

There is still further work which could be done to enhance the skills and competencies of accounting and finance personnel.

RECOMMENDATION

That Treasury pursue the development of competency standards for accounting and finance positions for the public sector.

5.9.5 Have agencies established adequate asset registers which form the basis for Total Asset Management plans?

From the survey information gathered, respondent agencies were confident that their asset registers were sufficient to allow them to formulate total asset management plans. Indeed, a majority listed asset management plans as being one of the benefits of the implementation of accrual accounting. Agencies feel that they now have better control over their assets and can accurately chart movements and plan for major maintenance and overhaul on a more regulated basis.

Prior to the introduction of accrual accounting, agency asset keeping records were poor. Most agencies indicated that they kept a rudimentary system of plant cards for recording various items, but often these cards were not kept up to date. Consequently, asset records were often inaccurate. A specific example of the problems facing agencies in the beginning is given by Mr David Rowland, Director of Properties, Department of School Education:

> *The problem the Department of School Education faced in endeavouring to value its assets and establish an appropriate depreciation component was that it really did not have a very comprehensive and descriptive inventory of all of its assets. It had its assets by schools and by floor area but not by condition and method of construction. It had age data. To achieve the time lines and the targets it would have been very expensive to have each of those individual assets valued. It would have been several million dollars worth of valuation work which would not, in our opinion, have yielded data which was necessarily complete and necessarily up to date.*[73]

Comments from agencies on asset information kept prior to accrual accounting are also reflected in the NSW Treasury's observations in its detailed submission:

> *Prior to the introduction of accrual accounting, agencies in the Budget Sector were already required to maintain an asset register under the Treasurer's Directions. The information contained in those registers was generally limited and little use was made of it in relation to the management of fixed assets. The details in the registers were often incomplete and not totally accurate particularly in the case of major agencies which had a large quantum and diversity of assets.*

One of the major benefits of introducing accrual accounting into Budget Sector agencies is that the State has now identified and accounted for a large quantity of assets which were previously 'lost' or 'hidden'. A number of agencies indicated that they undertook rigorous stocktaking procedures, and introduced computerised asset register systems to track and record identified assets, as well as place values on them for the first time. Asset policies were initiated and maintenance programs developed.

A specific example is provided by Mr Douglas Cook, Acting Director Finance, Roads and Traffic Authority:

> *That was probably one of the major selling points with the engineers as far as the need to revalue assets. We set up a system to value the road network. It involved calculating in year one the cost to rebuild the road network of New South Wales. At the time it was put at $23 billion. Then, using a system known as PMS - the pavement management system - it was calculated to cost $6 billion to bring the network back to near new, giving a written down value of $17 billion. The $6 billion was the magic missing gap as far as the perceived need to restore the network. Since then we have measured the movement in that asset condition. We are getting tremendous value out of that. The people who contribute to that are committed to saying how much the asset value is moving and decisions have been made on the maintenance required to minimise the deterioration. Accrual accounting has facilitated very much the total asset management plan for the authority in respect of infrastructure.*[74]

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73 Evidence to Committee, p. 46.

74 ibid. p. 7.

Another comes from Mr Jeffrey Wade, Finance Manager, Sydney Market Authority:

We have had a rolling 10-year maintenance plan for some time. That is now being updated to fit in with the Treasury circular on asset management. We expect to have that by the end of this financial year, or perhaps even earlier, so that we can plan. I have been there since 1988 and it has been used since then. There have been times when you try to stick to it as much as you can but something is always going to go wrong that you do not plan for. Sometimes you might have to leave things aside for that period. The advantage of having a 10-year maintenance plan, and also now the Treasury guidelines, is that they allow you now to provide for deferred maintenance slightly differently from the way we did it before. But at least if something happens which is not provided for it can be paid for out of profits and use the money later. So that is good.[75]

A further example of how organisations better appreciate their assets, and are able to give taxpayers a better understanding of the worth of public assets was also provided by Dr Drielsma, Managing Director, State Forests:

In terms of the financial management and reporting systems now, there are planning, monitoring, reporting systems. There is no doubt that right down through the organisation in terms of responsibility centres right down - and you would be aware that the local district foresters now have a very good understanding of the asset values that they are dealing with - from month to month they are monitoring that, reporting it through to senior management, evaluating the use of those resources and making decisions as to disposing of resources that are contributing; and looking very closely at that. I think it has had a fundamental effect right through the organisation on the way people are looking at that.[76]

Similarly, Mr Ken Barker, Department of Health, explained:

We have total asset management plans and that type of thing in place in line with government policy. My view is that we have improved the use of our assets in recent years. Certainly a large number of new facilities have been constructed, but by the same token some of the more inefficient services are no longer there because there is this fixed marginal cost issue with running a hospital. You have X number of staff and X number of patients and you still will have the same level of fixed costs. Then you have marginal costs above that, which will be sustainable for a while. But at a certain point you have to increase your fixed costs again. Some of our older infrastructure is not suitable for the way health is delivered in 1996. The simplest way, and this is an accountant's perspective, has to be either to provide a new facility, if that is needed in that location, which gives a much cheaper operating costs arrangement, or you build something new somewhere else and the old facility is no longer appropriate.

[Accrual accounting] can be one of the things that is available because as an agency we do not think what we can do with that asset if it is not going to be used as a health facility, and what it will give us in return, which we can then put back into health infrastructure somewhere else where it is needed. Our managers normally get that within their geographic area. If someone says, "I would like to dispose of this asset because I want that money to do this", providing it

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75 ibid. p. 85.

76 ibid. p. 28.

> *makes good health sense, we allow that process to occur. So, there is a benefit given in exchange to something that is foregone.*[77]

Based on these comments and those of the surveyed agencies, the Committee is of the view that agencies have progressed significantly towards the implementation of Total Asset Management systems. Agencies indicated that the guidelines and policies developed by Treasury to assist agencies in identifying, classifying and valuing assets have been of great assistance, though some were critical of the timing of these guidelines, suggesting they should have been available earlier in the implementation process.

A significant number of respondents indicated their main concern in respect to assets was the issue of asset valuation which has been covered in detail in Chapter 4 of this report. The Committee is aware that a number of agencies are still experiencing problems with respect to assets, particularly those valuing heritage assets (the Royal Botanic Gardens), land under roads (e.g. Roads and Traffic Authority) or plantations (Forestries), or where the public sector and private sector unite to build public infrastructure.

The Committee has previously tabled in Parliament a series of reports on the financing of infrastructure in the public sector and has noted the lack of accounting standards which could apply to infrastructure, causing uncertainty about the most appropriate accounting treatment. The Committee's concerns were echoed and reiterated during this inquiry, and support for development of appropriate standards was also forthcoming from Mr John Shanahan, Audit Partner, Deloitte Touche Tohmatsu, and Mr Tony Harris, Auditor-General:

> *Mr Shanahan: If we develop and promulgate a standard, that will certainly clarify the accounting issues. There are problems to be faced in developing a standard and we have not started to chip away at them. It is quite clear from an accounting-cum-finance aspect that we need to finance infrastructure developments, and I believe that introducing private sector financing together with the public sector is the way to go. As to how we actually account for these two streams of financing in one project, I do not believe we have a satisfactory answer to the accounting issues there at the moment. You can look at the Sydney Harbour Tunnel, the tollways, or Port Macquarie Base Hospital. They have all given us an accounting problem because at the moment we have an inadequate set of tools. We either have to address the issue as plain debt or equity financing, and it is neither. The audit office puts a lot of store in classifying them as a financing arrangement in the nature of a lease, and technically they are not actually leases. They are not quite joint ventures, and that was the approach tried with the Sydney Harbour Tunnel.*
>
> *At the moment we have a number of approaches, all of which we are trying to apply by analogy, none of which quite work. The Audit Office, in its mind quite properly, issues qualified reports because nothing quite fits all the check books. A standard on infrastructure development and financing thereof will put a number of these issues to rest. But in trying to get agreement on what*

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77 ibid. p. 37.

should be in that standard and how it should work, I am aware the big six accounting firms are generally split about three-all on which approach to take. When you cannot get any uniformity of approach from the big six, the Audit Office has an approach which some like and some do not, and Treasury has a different view. I do not believe that standard will be forthcoming rapidly. It will take a fair time to get to it. We need it but I think development time still has a long way to go.

I believe strongly we should account for our infrastructure assets. The whole point of accrual accounting is that we want to identify what resources are being employed by the reporting entity, in this case by the public sector of New South Wales. If we have assets which are providing a benefit and we are not recognising them then to a large extent we are kidding ourselves. When you look at the types of infrastructure projects such as the Sydney Harbour Tunnel, tollways, freeways, the airport rail link and that sort of thing, they are resources of the State. Not to recognise them in our asset base is to distort our asset measurement and it can result in misallocation of resources. The accounting profession as a whole has been taking the approach that if the measurement is too hard we put the issue to one side and just make extensive note disclosure.[78]

Mr Harris: When I first said the accounting standards were not appropriate, the accounting profession disagreed. When I say "the profession" I do not mean Price Waterhouse, I mean the professionals: Australian Accounting Research Foundation - AARF - and the like. They were of the view that accounting standards were adequate. Maybe they had in their mind that some of the statements of accounting concepts that had been introduced would, if they remained on the books, be adequate. But those statements of accounting concepts were reduced from being mandatory to advisory only, and thus they do not provide the kind of support needed to determine the relationship. More than that, some of the recent standards said that the concepts are not necessarily applicable for whole of government. There was a response to say that we do no need new standards. Now there is an acknowledgment that the economic relationship between the Government and the economy is so sophisticated that private sector standards are not adequate, and they are working on a standard. We have seen some papers illustrating their thinking, and if they go down that track it becomes mandatory. If Treasury does not oppose it in the sense of override it, it will become a very important way of solving these problems.[79]

Mr Harris reiterated this issue at the Public Accounts Committee's Seminar on Accrual Accounting:

. . . it seems to me that the accounting standards have developed very slowly over time and that if economists had the same standards as accountants, we would all be trading in gold, instead of having financial notes.

So the accounting standard has lagged processes somewhat and this is particularly so for government sectors because the government sector deals with the economy in a much more sophisticated way, a much more interesting way than does the private sector deal the the economy and I do not think the accounting standards have developed to enable that recognition to be given to those difficulties and differences.

78 ibid. p. 55-6.
79 ibid. p. 75.

Summary

The Committee is not satisfied, from evidence given by the Valuer-General, the Treasury and the Auditor-General, that the issue of asset identification and valuation has progressed sufficiently towards resolution. Nor is the Committee convinced that the accounting bodies and standard setters have given the issues of valuation of public sector assets and the private sector provision of public infrastructure sufficient attention and priority. It is possible that this inaction has contributed significantly to:

- confusion as to how to fully disclose the value of public sector assets (some may still be omitted because of this confusion, e.g. infrastructure assets);
- delaying agencies' ability to fully implement government policies on total asset management;
- general confusion by agencies as to the use of appropriate valuation methodologies; and
- inability of agencies to utilise accrual accounting information fully.

RECOMMENDATION

That accounting bodies and associated accounting standard setters raise the profile of two main issues in their work programs: the public/private provision of infrastructure and the valuation of public sector assets. These bodies, such as the Australian Accounting Research Foundation (AARF), should work in consultation with Treasuries and Auditors-General in ensuring appropriate and consistent standards are developed and implemented as soon as possible. The Committee considers this considerably overdue.

5.10 General observations

5.10.1 The Role of Treasury

5.10.1.1 Implementation timetable and expectations

A number of survey respondents indicated that Treasury expectations and implementation timetables were unrealistic and that Treasury had demonstrated little understanding of day-to-day activities and of difficulties associated with meeting implementation deadlines and requirements. It is understandable that for some agencies, the change to accrual accounting was neither a quick nor simple task. It is also understandable that Treasury may have had insufficient resources to assist some agencies to the extent the agency required or needed.

It is apparent that the smaller agencies were the ones most likely to encounter difficulty. As with any change process, there are lessons to be learned in hindsight.

Any further changes or enhancements to the accrual accounting agenda should be better planned and thought out beforehand, and that extra consideration should be given to the impacts of these additional changes on smaller agencies.

5.10.1.2 Providing Training and Support

As discussed previously, agencies were generally supportive of the initial training provided to them by Treasury in the early stages of the implementation, though several comments from the survey suggest that some smaller agencies may not have taken full advantage of the training offered, particularly for non-accounting staff. As training appears to have been voluntary rather than compulsory, the Committee believes that the importance of gaining an understanding of the impacts and implications of the introduction of accrual accounting did not completely reach all levels of the target audience. In hindsight, it would have been better to have made this training compulsory to ensure information filtered to all staff within Budget Sector agencies.

Most survey respondents agree that on-going training is not necessary, and indicate that they rely on advice and assistance from Treasury on an ad-hoc, as-needs, basis. This is sufficient given that most agencies have had a minimum of two years under a full accrual accounting system, and should have progressed sufficiently to enable them to handle general accounting issues and day-to-day operational requirements. However, they should not rely solely on external agencies such as Treasury and the Audit Office for advice, but should endeavour to build their accounting skills and competencies internally.

The implementation of further initiatives, for example, changes to budget monitoring, performance measurement, resource budgeting and service costing, will require Treasury to develop training strategies, in consultation with agencies, and to implement suitable programs to ensure that all Budget Sector organisations fully understand background concepts and theory, and are confident and sufficiently competent to implement the required procedures and practices. It is suggested that Treasury make such training compulsory for all staff within Budget Sector agencies, and that these programs be scheduled with sufficient lead time to enable agencies to participate fully.

5.10.1.3 Providing Accounting Policy & Guidelines

There is a continuing role for Treasury in the development and provision of accounting policy and guidelines. The PAC survey sought responses to the guidelines and policies which were developed and implemented as the result of the introduction of accrual accounting. Three agencies were critical of the lack of policy and guidelines on certain issues at the start of the change process, and commented that Treasury had not been proactive in developing policy and guidelines. This again suggests that it is easy to be wise in hindsight. However, as there are a number of current issues still on the table, Treasury would be well advised to ensure that policies and guidelines are available to all agencies before agencies are required to adhere to them.

Agencies responding to the Committee's survey were supportive of Treasury's ongoing role in the development of policies and guidelines which ensure a consistent approach to accrual accounting across the public sector. However, several comments indicate that agencies often become caught in disputes between Treasury and the Audit Office over the application of accounting standards and Treasury policies. This is particularly prevalent when Treasury policy differs from accounting standards. One agency indicated that, where this was the case, they were more likely to follow the advice and requirements of the Auditor-General, rather than risk qualification of their statements.

Other comments were of a similar nature, indicating that agencies felt Treasury should not promulgate policies or guidelines which differed from accounting standards, but should endeavour to align their accounting policy more with Australian Accounting Standards.

The Committee is concerned that the differences of opinion between Treasury and the Audit Office on matters of application of accounting standards and accounting policy may be to the detriment of building a more accepting attitude towards accrual accounting, particularly on the part of those agencies who have, or are, experiencing difficulties in this area. The Committee understands that these disputes are often isolated instances, but even so, they have been of sufficient magnitude for agencies to bring them to the attention of this inquiry.

RECOMMENDATIONS

- That Treasury ensure that accounting policy and guidelines on accounting issues adhere to the requirements of the Australian Accounting Standards as promulgated and issued by the Australian Accounting Research Foundation.
- Where it is evident that an accounting standard does not apply in part or in total to the public sector, that the NSW Treasury consult with the relevant accounting standard setting bodies, the Audit Office and relevant agencies, before issuing policy or guidelines for use.

APPENDIX ONE

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APPENDIX TWO

		Received & Complete	Received: -blank -letter of explanation -referral to other dept
1	Dept Training and Education	x	
2	Office of the Board of Studies	x	
3	Judicial Commission	x	
4	Environmental Protection	x	
5	Home Care Service	x	
6	Rural Assistance Auth	x	
7	NSW Dept of Transport	x	
8	NSW Agriculture	x	
9	TAFE Commission	x	
10	Attorney General's	x	
11	Home Fund		x - letter of explanation
12	Dept of Energy	x	
13	Centennial Pk & Moore Pk Tst	x	
14	Health Care Complaints	x	
15	Office of Marine Safety		x - now outer Budget - N/A
16	State Electoral Office	x	
17	Dept of Gaming & Racing	x	
18	Mineral Resources	x	
 19 20 21	Land and Water Conserv: Soil Conserv Dept Lands Dept Water Resources Dept Conserv & Lnd Mgmnt Dept of Land & Water Conserv		 x -A/acctng in before fomation x - A/acctng in before formation
22	National Parks and Wildlife	x	
23	NSW Fisheries	x	
24	Roads & Traffic Auth	x	

25	Ageing & Disability	x	
26	Dept School Education	x	
27	Dept Corrective Serv	x	
28	State Emergency Services	x	
29	Royal Botanic Gdns	x	
30	NSW Crime Commission	x	
31	Dept Fair Trading	x	
32	Casino Control Auth	x	
33	Bicentennial Park Trst	x	
34	Dept Public Works	x	
35	Tourism NSW	x	
36	Sydney Market Auth	x	
37	Ambulance Serv		x- referred to Health Dept
38	Urban Affairs and Planning	x	
39	ICAC		x - letter of acknowledgement only
40	Dept Industrial Relations		x - letter of ackowledgement only
41	Dept Local Government	x	
42	Legal Aid	x	
43	Treasury	x	
44	Police Service	x	
45	Sport & Recreation	x	
46	Community Services	x	
47	Fire Brigades	x	
48	Dept for Women		x - incomplete but some info used
49	Ethnic Affairs Commission	x	
50	Office of Director Public. Pros	x	
51	State & Regional Develop	x	

APPENDIX THREE:

Policy Guidelines for the valuation of physical non-current assets

in the NSW Public Sector

NSW Treasury technical paper, September 1990

NEW SOUTH WALES

POLICY GUIDELINES FOR VALUATION OF PHYSICAL NON–CURRENT ASSETS IN NSW PUBLIC SECTOR

**New South Wales Treasury
Technical Paper**

September 1990

POLICY GUIDELINES FOR VALUATION OF PHYSICAL NON-CURRENT ASSETS IN NSW PUBLIC SECTOR

Table of Contents

Preface

The Treasury issued a Report entitled "Accounting Guidelines for Reporting Physical Assets in the Budget Sector" in November 1989. While the paper was generally well received, many expressed the view that a more definitive set of criteria should be developed to link each broad category of assets and the appropriate method of valuation to be applied.

This Report provides a framework and a set of guidelines to assist public sector reporting entities in the valuation of their physical non-current assets. The present paper complements rather than supersedes the previous Accounting Guidelines of November 1989. It has a wider scope since the valuation guidelines are applicable to all public sector reporting entities.

It is intended that all public sector reporting entities will revalue their assets at a common date several years from now. While valuation of assets on a current cost basis will be mandatory for all public sector reporting entities from that date, departments and inner Budget authorities should endeavour to value assets on this basis when they implement accrual accounting for the first time. From then on it is envisaged that asset revaluation will be conducted every 5 years. In respect of newly acquired assets however, acquisition cost of these assets between two revaluation dates is generally to be used since it approximates current cost. As a result, the consolidated financial statements for the State public sector will become more comparable in future years.

The paper was prepared by Stephen Lim, Manager, Accounting Policy Branch, with input from Mrs Thuy Mellor, Chief Accountant, and Bob Scullion, Assistant Secretary, Treasury.

Enquiries concerning the valuation guidelines in this Report should be directed to Mrs Thuy Mellor (228-4050) or Henry Maleszka (228-3264). We would welcome comments on the issues and other matters raised in this document.

Percy Allan

Secretary
NSW Treasury

SUMMARY OF VALUATION GUIDELINES

(i) **Broad Classification of Physical Non-current Assets**

Based on their potential availability for alternative use, including disposal, public sector physical non-current assets can be divided into three broad categories:

(A) assets which may, under present legal and policy provisions, be redeployed or disposed of.

(B) assets which are not currently available for redeployment or disposal by reason of legal or policy constraints, but

(1) which could reasonably become so available, within the context of the prevailing political, social and economic system, or

(2) which need to be maintained with the expectation that they would be replaced by assets closely resembling them.

(C) assets which are not currently available for redeployment or disposal and for which there is no reasonable expectation of change.

(ii) **Valuation of Physical Non-Current Assets**

A method of valuation is explicitly linked to each category of physical non-current assets (see also Flowchart for Selection of Method of Valuation, p. 20):

Category	Balance Sheet Valuation
(A)	Market value, including net realisable value and expert appraisal.
(B1)	Market value, with footnote reference.

Category	Balance Sheet Valuation
(B2)	Written Down Replacement Cost (for Physical Assets other than land) OR Existing use valuation subject to any restrictions or enhancements since acquisition (for land).
(C)	No valuation is required for balance sheet purposes.

(iii) **Depreciation of Physical Non-Current Assets**

Category (A), (B1) and (B2) assets should be depreciated, where applicable, on the basis of their expected life, where this is below the accepted threshold period (200 years has been proposed as the threshold). For category (C) assets, for which no valuation is required, no depreciation charge is applicable.

POLICY GUIDELINES FOR VALUATION OF PHYSICAL NON-CURRENT ASSETS IN NSW PUBLIC SECTOR

1. INTRODUCTION

Following comments received from and discussions with various interested parties in respect of the New South Wales Treasury paper entitled "Accounting Guidelines for Reporting Physical Assets in the Budget Sector" (November 1989), several concepts pivotal to valuation of assets have been revised and further refined. In particular, it was generally felt the broad classification of physical assets into heritage and other assets was somewhat arbitrary.

Valuation of some physical non-current assets presents a particular problem in the public sector due to several factors which do not apply to the private sector. Firstly, some public sector assets are not available for redevelopment or disposal in the foreseeable future. Secondly, revenue-generating potential of these assets is often not readily measurable. The government's investment in such assets is funded through general taxation and the decision to construct or build them has little to do with commercial investment criteria such as the rate of return on investment commonly used by the private sector.

The focus of this paper is the valuation of physical non-current assets which are "peculiar" to the public sector and do not conform to private sector conceptions of what generally constitutes assets. While there is no need to go over the same grounds which were covered in the Accounting Guidelines of November 1989, it would be convenient to reiterate and expand on the key concepts concerning the main types of assets to be discussed.

In Section 2 the main functional categories of public sector physical assets are outlined, namely infrastructure assets, restricted use assets, and heritage assets. The following section gives a summary of the alternative bases of asset valuation. Section 4 then concludes the review of the key concepts used in the Accounting Guidelines.

Section 5 presents a more definitive classification of physical non-current assets based on their potential availability for alternative use. This is followed by an exposition of valuation approaches which are considered appropriate for each of the categories of assets.

Specific as well as general examples are given for each category. These valuation guidelines conclude with a brief statement on the applicability of depreciation to those categories of physical non-current assets.

2. MAIN FUNCTIONAL CATEGORIES OF PHYSICAL NON-CURRENT ASSETS

2.1 Infrastructure Assets

The term "infrastructure" includes all non-current assets comprising the public facilities that provide essential services and enhance the productive capacity of the economy. It includes such public sector assets as roads, bridges, railroads, sewerage systems, water supply systems and reservoirs, power generation plants and transmission lines, police stations, courthouses, schools, hospitals and other government buildings.

In the normal course of operations, infrastructure assets are expected to be replaced. That is, as long as people live within confines of a city, essential services produced or facilitated by such means as power generation plants, water and sewerage systems, schools and police stations are presumed to be always required.

2.2 Restricted Use Assets

All physical assets including infrastructure assets, whether held by the private or the public sector are subject to natural and legal restrictions on their use. These restrictions may arise out of:

(1) limits inherent in the asset itself;

(2) limits imposed by government entities;

(3) limits imposed by a donor or grantor; and

(4) self-imposed limits

The general practice in both the private and public sectors is to record physical assets at market values that reflect all restrictions in effect at the time the assets were acquired. Any restrictions placed on the use of an asset after acquisition which resulted in a reduction in market value may require a write-down in the value of assets.

2.3 Heritage Assets

The expression "heritage assets" refers to those non-current assets that a government intends to preserve indefinitely because of their unique historical, cultural or environmental attributes. A common feature of heritage assets is that they cannot be replaced (e.g. monuments, historic museum collections, wilderness preserves and historic buildings).

There are a number of physical assets which have been designated heritage assets in the sense that a conservation order has been placed on them. However, a conservation order does not necessarily restrict the pre-existing use of those assets, for instance as commercial premises. Consequently there would be no need for a valuation write-down in such circumstances.

3. ALTERNATIVE BASES OF ASSET VALUATION

(i) Historical Cost

- Historical cost refers to the original purchase cost of an asset.
- Historical cost may not reflect the underlying value of the asset if it was purchased many years ago, especially in times of high inflation (resulting in an understated value); or conversely, in times of rapid technological obsolescence (resulting in an overstated value).

(ii) Current Replacement Cost (Entry Price)

- This valuation estimates the current cost by reference to the cost of the most appropriate modern replacement facility. It applies where the asset being valued could be replaced in the normal course of business at balance date by a different asset (in terms of scale and/or technology) having a similar service potential or future economic benefit.
- The great majority of physical assets which have been constructed can be reconstructed or replaced (but without necessarily reproducing/replicating their exact physical attributes)

- However, unless there is a reasonable expectation that if the existing asset were disposed of, it would be replaced by another asset closely resembling it, the relevance of replacement cost becomes remote and difficult to assess.

(iii) **Market Valuation (including Expert Appraisal)**

- This valuation utilises the current cost as determined by reference to an obtainable market value for the asset or an appraisal by a recognised authority.

- Only meaningful if there exists a market for valuing the asset or similar assets.

(iv) **Net Realisable Value/Net Cash Inflow (Exit Price)**

- Where the service potential of an asset would not be replaced, or has already been replaced by some other asset, the asset should be brought to account at its realisable value or at the net cash inflow (ie total inflow less total outflow) that would be realised from its continued use, whichever is the higher.

4. ASSET VALUATION PRINCIPLES

As a general principle, assets should be brought to account at their current cost valuation measured by the lowest cost at which the service potential or future economic benefits of the asset could currently be obtained in the normal course of business. Such an approach is to be adopted by all departments and authorities in the budget sector preparing balance sheets for the first time.

Ideally, valuation would be determined by reference to the market price but in many cases this is not possible due to the absence of a realistic market for the assets involved (e.g. buildings or plant of special design).

Public sector assets are often different from private sector conceptions of what constitutes an asset, particularly in terms of the degree of control exerted by the reporting entity and its ability to restrict access to the service potential or economic benefits derived from the asset.

In a business enterprise (public as well as private sector), control over the service potential derived from an asset is invariably achieved by restricting access to end products to those willing to pay for them. Non-commercial public sector reporting entities on the other hand are often unable to restrict individual access to the use of the service potential derived from an asset, eg. roads, railroads, hospitals and other government buildings.

The concern is not over whether a physical structure in fact constitutes an asset. Rather, at issue is the appropriate valuation method to be adopted by reporting entities on whose balance sheets these assets are to appear. More importantly, one needs to know the purpose for which the values are to be used and whether the values assigned to these assets on the balance sheet of a particular reporting entity are meaningful.

5. BROAD CLASSIFICATION OF PHYSICAL NON-CURRENT ASSETS

The previous sections have summarised the key concepts used in the Accounting Guidelines issued in November 1989. As mentioned earlier, subsequent comments received from many interested parties indicate that the classification of physical assets into heritage and other assets was somewhat arbitrary. It was felt that a more definitive set of criteria should be developed to explicitly link each category of assets and the appropriate method of valuation to be applied. To this end, **the availability for alternative use of an asset is believed to be most useful as a basis for linking the categories of assets so defined, and the valuation methods to be employed.**

Problems arise in applying any meaningful valuation to assets which by their nature or location are subject to restrictions as to their use or disposal. Based on their potential availability for alternative use, including disposal, public sector physical non-current assets can be divided into <u>three</u> categories. (It is also possible to use other bases of classification, eg. potential for revenue generation where some assets such as power generation plants may contribute directly to the earnings of the reporting entity).

The following categories of assets do not take into account such chattels as vehicles, computers and other equipment for which replacement is a normal expectation, and for which the normal accounting practices used in the private sector are applicable:

(A) assets which may, under present legal and policy provisions, be redeployed or disposed of.

(B) assets which are not currently available for redeployment or disposal by reason of legal or policy constraints, but

(1) which could reasonably become so available, within the context of the prevailing political, social and economic system, or

(2) which need to be maintained with the expectation that they would be replaced by assets closely resembling them.

(C) assets which are not currently available for redeployment or disposal and for which there is no reasonable expectation of change.

6. VALUATION OF PHYSICAL NON-CURRENT ASSETS

6.1 Category (A) Assets

For category (A) assets, it is suggested that **estimated market value or Net Realisable Value, periodically updated by expert valuation**, is the most appropriate basis of valuation.

If the reporting entity has control over its asset and alternative use is a real possibility, i.e. the asset is readily available in the market place, then market valuation (including expert appraisal) is relevant. Valuation will depend on the nature of control over the asset and the options available for alternative use. Category (A) assets where redeployment or disposal is an available option would include the following:-

. Surplus Land - market valuation based on adjacent usage valuation and orderly disposal

eg. land near roads, railways and transmission lines may be valued at farm land or residential land valuations.

. Buildings - market valuation based on existing or alternative usage valuations and orderly disposal

- Works of Art - market valuation based on expert appraisal and orderly disposal

  eg. paintings and art collections may be valued by experts.

Other Examples of Category (A) Assets

Both the Department of School Education building in Bridge Street and the State Office Block in Macquarie Street are available for disposal in accordance with current government policy. Accordingly, valuation of these buildings may incorporate market valuation based on their existing use as office accommodation in the central business district of Sydney, or their potential use as sites for redevelopment projects.

A less tangible asset associated with public sector assets relates to the air space rights over land occupied by railway stations. It would of course be premature and unrealistic to assign values to air space rights over land in every railway station. The point in time when it would be reasonable to assign a market value to such air space rights is dependent on several factors. Firstly, there must have been genuine expressions of interest to utilise the air space. Secondly, reliable measures of valuation must be available. Any capitalisation of the air space rights would have to be determined on a case-by-case basis and must also have regard to the terms of agreement for the acquisition of the air space rights.

6.2 Category (B1) and (B2) Assets

6.2.1 Where Estimated Market Value is Available- Category (B1)

For category (B1) assets, again it is suggested that **estimated market value where available be used**, but with the proviso that a footnote reference be placed against each such item or a group of items. The footnote should specify that the valuation is based on a market value which assumes the absence of constraints on alternative use or disposal, although the prevailing situation may prevent or limit any such action.

Category (B1) assets would include schools, hospitals and ambulance stations which have been earmarked by Government for disposal. Where at the date of valuation, if in fact alternative nearby facilities such as another ambulance station are being constructed or have been built, then such an existing asset should be included in Category (A). In that instance market valuation will be relevant. The only difference arising from moving a Category (B1) asset to Category (A) is that it would not be necessary to provide a footnote reference against such items.

6.2.2 Where Market Value May not be Available- Category (B2)

In most other cases, where the service potential of infrastructure assets is to be maintained and continued then those assets should be valued at **Written Down Replacement Cost** for physical assets other than land, or **existing use valuation** subject to any restrictions or enhancements since acquisition in the case of land. Neither historic cost nor market valuation is particularly relevant or meaningful in these situations, particularly since alternative use is not feasible under current circumstances.

Category (B2) assets where redeployment or disposal is not an available option would include the following:-

- power plants
- transmission lines
- police stations
- courthouses
- schools]
- hospitals]not earmarked for closure
- ambulance stations]
- roads and bridges
- railways
- sewerage and water supply systems

Generally, these public facilities provide essential government services which will be maintained and continued in the foreseeable future. Written Down Replacement Cost (or Written Down Reproduction Cost) is particularly relevant because there is a reasonable expectation that if the existing asset were disposed of, it would be replaced by another asset closely resembling it.

6.2.3 Land Under Roads and Railways

For assets such as roads and railways, the land component becomes an inherent part of the infrastructure once the roads and railways have been built. While the land might have previously been used as farm land and acquired at a cost which reflects that particular use, its current use as land under roads and railways would suggest that **the nature of its utility has undergone a substantial change**. Thus it would no longer be appropriate to adhere to valuation at cost of acquisition for such land.

Whereas the farm land previously had alternative use, the same land under roads and railways generally has no plausible alternative use as it has now been dedicated to roads and railways. Due to its restricted use since original purchase, land under roads and railways should be revalued according to its existing use in terms of Australian Accounting Standard AAS10 (Accounting for Revaluation of Non-current Assets).

It is also conceivable that land under roads and railways, over time, might appreciate in value. For instance, the geographical shift of population could mean that the land becomes much more valuable if it is located close to growth areas. Should a decision be made to divert traffic to another route, the land currently under roads and railways has potentially an alternative use, e.g. redevelopment for industrial or residential purposes. At such time the appropriate valuation method to be applied would be market value or net realisable value under Category (A).

6.2.4 Assets Having Excess Productive Capacity

Certain infrastructure assets of the larger reporting entities might have been constructed using a set of assumptions and demand forecasts which no longer apply. In line with the general principle of using Written Down Replacement Cost for Category (B2) assets other than land, a downwards revaluation should be undertaken to reflect any excess productive capacity. Such an approach is not inconsistent with Australian Accounting Standard AAS10 (Accounting for the Revaluation of Non-Current Assets) paragraph 23:

"A downwards revaluation of a non-current asset should be undertaken only where the carrying amount is greater than the amount that is expected to be recovered from the continued use and, where applicable, disposal of that asset; that is, its recoverable amount. In this situation the asset should be revalued to its recoverable amount".

6.3 Category (C) Assets

For category (C) assets, it is unreasonable to assign any value, since the asset has neither market value nor prospect of alternative use. It is suggested that a non-numeric symbol or a $1 nominal value, also explained in a footnote, be inserted in the money column, to indicate an asset whose value is not reasonably measurable.

Further, if assets are subject to natural and legal restrictions on their use such that the reporting entity has little or no control over alternative use or disposal of those assets, then they should be shown in the balance sheet as record only with appropriate notes to the financial statements. In other words, it seems reasonable to write down the recorded historic value of physical assets in order to reflect any impairment in value that arises from the restrictions placed on them.

6.3.1 Specific Examples of Category (C) Assets

(i) Royal Botanic Gardens, Centennial Park, National Parks

If the Valuer-General were requested to value the Royal Botanic Gardens, the first question he would ask is likely to be: What assumptions regarding its use should be made? Existing use, commercial rezoning, or perhaps residential development?

Under existing use assumption, there can be no taker even if it were offered for free to a private operator, since it is a loss-making operation. It may need 50 people all year round just to keep the Royal Botanic Gardens in good order, let alone other maintenance costs. (In this regard the reporting entity's notes to the accounts should clearly indicate costs of operating and maintaining the asset).

Hypothetical uses for the Royal Botanic Gardens include uses for residential or industrial development. However, until such time that a decision has been made by the Government to look at alternative uses for them, neither historic cost nor any purported market valuation can be meaningful. Therefore, Royal Botanic Gardens should be shown as record only in the balance sheet.

The above observations concerning the Royal Botanic Gardens apply equally to Centennial Park and National Parks.

(ii) **Government House, Parliament House, Historic Houses**

Over time Historic Houses have acquired attributes which are valued by the community by virtue of their representing an architectural style of a past era, their use as a place of residence by persons of note, or their historical significance as a landmark.

The Parliament House and the Government House are somewhat more functional than Historic Houses. However, constraints on their existing use would preclude any meaningful valuation unless an alternative use becomes a distinct possibility.

At what point in time do physical structures such as the Parliament House and the Government House become Category (C) assets?

Upon completion, such a structure would initially be recorded at cost and depreciated accordingly, unless the estimated useful life is more than 200 years (see Section 7.2 for a discussion on assets with very long lives). Accounting for the particular asset in subsequent years would depend on an assessment to be made periodically of its characteristics in the light of prevailing community expectations and attitudes, principally the availability of the asset for redeployment or disposal.

Over a long period of time, it is conceivable that physical non-current assets, which have moved from Category (B2) to Category (C), could move back to (B1) or Category (A). What is relevant at the time of valuation is the judgement which must be formed in determining the potential availability of assets for alternative use, including disposal.

(iii) Certain Museum, Archival and Other Collections

Particular museum, archival and other artefacts may be designated not available for disposal by virtue of their unique historical and cultural attributes. For example, certain of the Australian Museum's Australiana collections are unique because they are one of a kind and therefore irreplaceable. Where they are merely representative of a collection which is available or found elsewhere, and is therefore less than unique, they should be valued where practicable.

Archival collections which are one of a kind, e.g. a former Colonial Governor's diary, are usually intended to be preserved indefinitely because of their historical significance. In this regard they are comparable in nature to Historic Houses.

Copies of archival collections, though valuable in their own right, do not attain the status of the originals. Since they are not unique, they should be valued where feasible, as should model Historic Houses used for recreational and educational purposes.

(iv) Memorials

While Historic Houses do not begin to be regarded as having historical and cultural attributes until a considerable passage of time, memorials by their very nature are akin to "instant" Historic Houses. Whereas future candidates for Historic Houses in a sense await history to unfold, memorials are built as a consequence of some historic event having already taken place.

Schedule of Category (C) Assets

Schedule 1 lists the specific physical non-current assets for which no valuation is required.

Where Departments and Authorities are of the view that certain of the assets under their control warrant inclusion in the Schedule of Category C assets, they should consult with Treasury in the first instance.

6.3.2 Exceptions to Category (C) Assets

(i) Sydney Opera House

Unlike the great majority of other structures which merely function as one factor of production in the delivery of goods and services, the Sydney Opera House possesses certain attributes which are unique. As distinct from structures such as school buildings, ambulance stations and power plants, the Sydney Opera House has acquired cultural attributes which now extend far beyond its functional capacity in simply providing accommodation for the performing arts.

Because these unique attributes can not be duplicated or replaced, replacement cost valuation for the Opera House is not particularly meaningful. To arrive at a replacement cost figure one must essentially make a set of assumptions, including its reconstruction along similar design and structure. If such assumptions are not explicitly made, then other assumptions would have to be invented, ie. replacement cost for some other structure but not the Sydney Opera House. In either case this would ultimately produce replacement cost figures which are tenuous and not particularly meaningful.

The mix of unquantifiable cultural attributes and functional capacity thus poses a valuation problem. For balance sheet purposes, at least in the shorter term, the Sydney Opera House may be shown at historical cost.

(ii) State Library, Art Gallery

For the same reason that it would not be meaningful to arrive at a replacement cost figure for the Sydney Opera House, the State Library and the Art Gallery may be shown at historical cost for balance sheet purposes. However, for the old wings of these structures which were erected a long time ago, clearly the values attached to them should not be taken literally, i.e., no more so than a nominal value.

6.4 Valuation of Land in the Public Sector

In the private sector, the acquisition of land is usually based on the premise that its continued use will be substantially along the same line as its pre-acquisition use. Apart from certain elements of speculation, zoning restrictions are such that the purchaser would have reasonably clear expectations of what can or can not be done with the land. For instance, a developer who invests in a block of land for office accommodation redevelopment in the Central Business District could expect to have reasonable assurance that the use he has envisaged for the land will not be substantially different from what he can actually do with it.

By contrast Governments may acquire land and with relative ease put it to different uses. For example, farm land could be compulsorily resumed and purchased by Governments and used for building roads, railways or some other dedicated use such as a sports stadium. In these instances, the nature of land usage subsequent to acquisition and further development is substantially different from its pre-acquisition usage.

In both the private and public sectors, valuation of land should reflect any restrictions or enhancements arising from development activities since its acquisition in order to give a more meaningful indication of its worth.

Land value is generally dependent on the range of use or potential use that applies to the land. For land that has other physical structures placed on it, its value must necessarily be related to the benefits that these physical structures themselves generate. In terms of its relationship with the range of use and physical structures that it accommodates, land may fall into one of the following (which by no means is an exhaustive list):

Type of Land	Asset Category
. Surplus Land	(A)
. Land on which commercial buildings are erected	(A)
. Land on which other commercial and non-commercial structures are erected, eg. sewerage and water supply systems, power plants, schools and ambulance stations (not earmarked for closure)	(B2)

. Land on which other commercial and non-commercial structures are erected and the structures have been designated for closure	(B1)
. Land which has become an inherent part of an infrastructure eg. roads, railways	(B2)
. Land on which heritage assets are located eg. memorials, historic houses (other than those which strictly serve commercial purposes)	(C)
. Land which by itself is essentially a heritage asset in that it is not available for redevelopment or disposal and for which there is no reasonable expectation of change	(C)
. Forest land on which commercial crops are grown	(A)
. Land being used for waste disposal purposes	(B2)
. Developed Crown land	(A)
. Undeveloped Crown land for which no specific purpose has been identified	(C)

6.4.1 Valuation of Land in Category (A), (B1) and (B2)

Land and the physical structures placed on it should be valued separately where feasible. In the case of Category (B2) assets, written down replacement cost would generally apply to the physical structures. For the land component, existing use valuation subject to any restrictions or enhancements since acquisition should be adopted. In this regard, zoning restrictions will usually result in the land being valued relative to adjacent land usage. For example, land on which bus depots are located would have an existing use valuation that is largely dependent on adjacent land usage, i.e. current zoning restrictions as residential or industrial land.

Market value should be used for land in Category (A) and Category (B1). However, it may not be feasible to obtain meaningful market valuations separately for land and the physical structures placed on it. If the physical structures are special-purpose buildings, for instance, the purchaser would look to the range of potential uses for the land and consequently any price paid will reflect such expectations. In fact a valuation of the existing physical structures based on the pre-acquisition use of the buildings may be altogether irrelevant to the purchasing decision.

Surplus land having no physical structures placed on it would have a market value which is largely dependent on adjacent land usage and the range of potential uses allowed within the zoning restrictions. An important difference between land valuation in Category (A) or (B1) and Category (B2) may be contrasted as follows:

Category	Land Valuation
(A), (B1)	Market value based on potential uses as well as existing use.
(B2)	Existing use valuation subject to any restrictions or enhancements since acquisition.

7. DEPRECIATION OF PHYSICAL NON-CURRENT ASSETS

Category (A), (B1) and (B2) assets should be depreciated, where applicable, on the basis of their expected life, where this is below the accepted threshold period (200 years has been proposed as the threshold). For Category (C) assets, for which no valuation is required, no depreciation charge is applicable.

As a general principle, depreciation should be based on the cost basis for newly acquired assets, estimated market value for donated assets, or first time valuation for existing assets at the date of adopting accrual accounting <u>until</u> subsequent revaluations. Any increment in the gross value as a result of upward revaluation should be credited to an Asset Revaluation Reserve and not forming part of the operating results in the year of revaluation unless a write-down has been expensed in a prior year (Refer Australian Accounting Standard AAS10).

7.1 Electronic Equipment in a Network

For the purpose of determining the cut-off dollar value (currently at $5000) for which depreciation should apply, electronic equipment which forms part of a network are to be aggregated. Stand-alone cash registers, computers and other electronic equipment are to be expensed in the year of acquisition. It may still be appropriate however to record such items in an asset register for safe-keeping purposes.

7.2 Assets with Very Long Lives

For practical purposes, public sector assets with a life expectancy of over 200 years need not be depreciated. Included in this category of assets are certain infra-structure assets such as dams having characteristics not dissimilar to land used as a building site - their economic benefit or service potential is used up so slowly that the amount related to a particular accounting period is unlikely to be of consequence.

Apart from the obvious difficulty of ascertaining the useful lives of long-lived assets, i.e. whether they be 300, 400, or 500 years, any depreciation charges so calculated would be relatively insignificant in comparison to the ongoing operating maintenance costs and the costs associated with periodic "overhaul" maintenance.

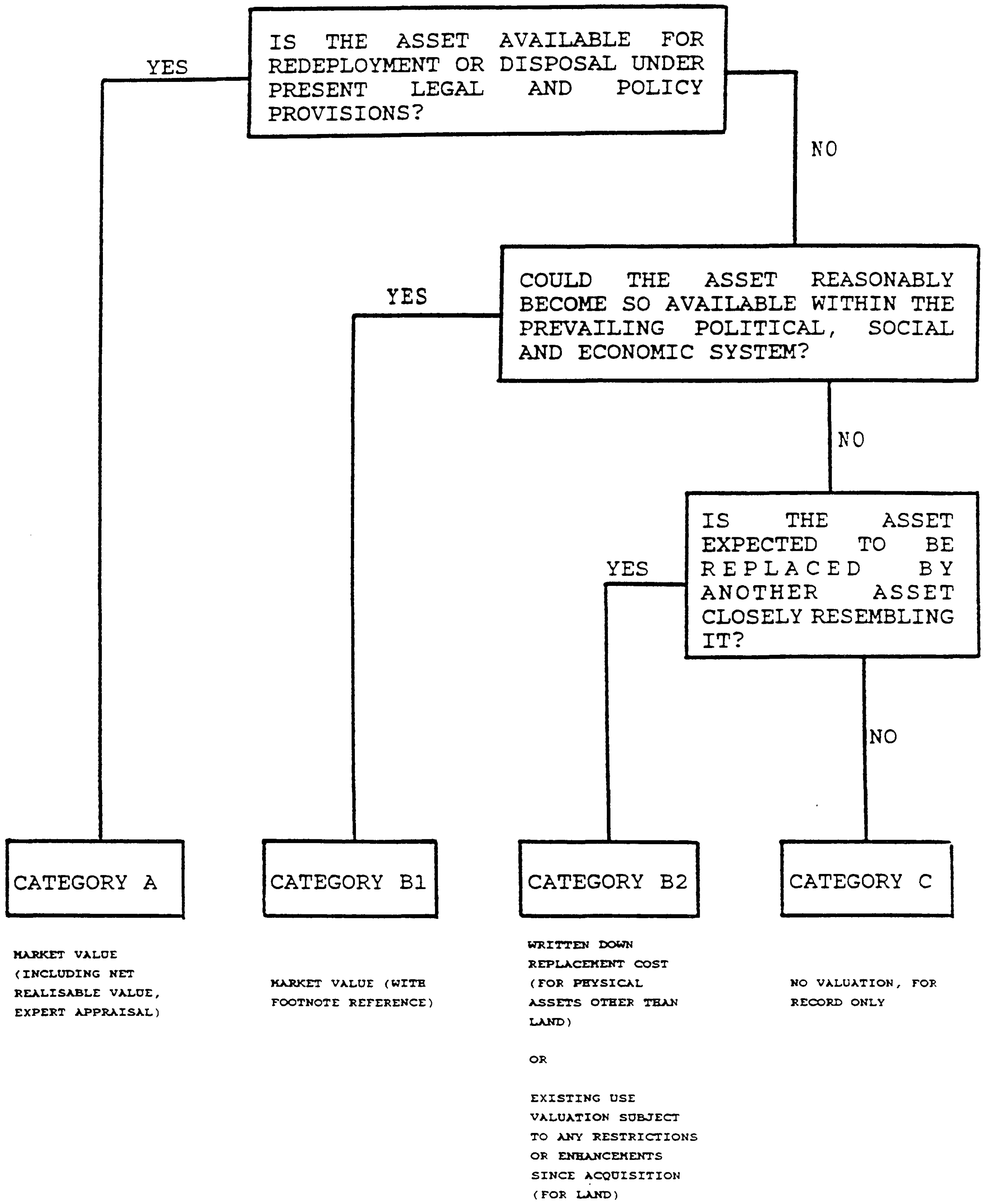
Should a reassessment at a later date identify an asset as having a useful life of less than 200 years, then at that point of time depreciation charges should be calculated and expensed in the usual manner.

8. CONCLUSION

The attached flowchart depicts the process of selection of the appropriate method of valuation for physical non-current assets.

Treasury has adopted this approach because it is applicable to a wide audience rather than specific users. Particular reporting entities encountering specific problems are advised to consult with Treasury prior to finalising their accounting practices on asset valuation and depreciation.

FLOWCHART FOR SELECTION OF METHOD OF VALUATION



Schedule 1

Schedule of Category (C) Assets

(1) Memorials, including land which forms an integral part of the site

(2) Museum, archival and other collections, excluding works of art, which have been designated not available for disposal because of their unique historical and cultural attributes

(3) National Parks

(4) Royal Botanic Gardens and the Domain

(5) Centennial Park

(6) Government House, including the land it occupies

(7) Parliament House, including the land it occupies

(8) Historic Houses, including the land they occupy.

APPENDIX FOUR:

Guidelines for the valuation of land and heritage assets in the public sector

NSW Treasury, May 1995

Guidelines

for the Valuation of

Land and Heritage Assets

in the

NSW Public Sector

NSW Treasury
May 1995

CONTENTS

1. Introduction

The purpose of the Guidelines is to ensure a consistent approach to the valuation of land (including land under infrastructure assets) and heritage assets in the NSW Public Sector for financial reporting purposes. The Guidelines seek to follow, as closely as possible, the normal principles and rules of valuation as applied by professional Valuers. It is intended that agencies will use the Guidelines as the basis for the preparation of the instructions to the Valuers when they are engaged to carry out the valuation.

The Guidelines have been developed by the Treasury with the assistance of the NSW Valuer-General. The valuation methodologies adopted have the general support of the valuation profession including the Valuer-Generals in the other jurisdictions and the Institute of Valuers and Land Economists.

The Guidelines are not intended to be prescriptive in terms of the detailed valuation methodologies which are a matter for the professional valuers. They are provided to give agencies a policy framework within which to undertake their individual valuations. The Guidelines must be applied by those agencies to which a Treasurer's Direction has been issued under section 9(2)(n) of the Public Finance and Audit Act.

2. The "Deprival Value" Concept

In October 1994, the Steering Committee on National Performance Monitoring of Government Trading Enterprises (GTEs) issued a comprehensive document on asset valuation. The document was developed following an extensive process of consultation with a wide range of interested parties including the Commonwealth/State Treasuries and Departments of Finance, selected GTEs and departments, the Australian Accounting Research Foundation and the Auditor-Generals.

The broad policy framework as set out in that document has now been widely adopted throughout Australia by all levels of government. The Treasury has also endorsed that policy framework as being appropriate for application to all agencies in New South Wales subject to minor adaptations. In this regard, the existing Technical Paper entitled "Policy Guidelines for the Valuation of Physical Non-Current Assets in the NSW Public Sector" will be revised later this year with an application date to be specified. The practical Guidelines contained in this document will be incorporated in the new Technical Paper. It is expected that there will be some further refinement prior to incorporation in the light of operating experience.

The GTE asset valuation policy has adopted the view that the **"value-to-the-entitiy"** concept is the appropriate basis for measuring current asset values for financial reporting and accountability purposes. This particular concept recognises that, because of the imperfections of the markets in which the physical non-current assets of government agencies are exchanged, the value of the service potential of those assets to the agencies (as the owners) that control them need not necessarily correspond with their current net market selling price or exchange value.

In the GTE policy document, the "value-to-the-entity" concept has been translated into the concept of **"deprival value"** which is not a method of valuation but a guide to the bases of valuation which should be adopted.

"Deprival value" is defined as "... the loss which results to an owner from being deprived of an asset. It is the minimum cost of replacing the services rendered by the asset which measures the loss by deprivation". Conceptually, this approximates the true economic value of the asset in terms of its utility to the entity.

Conventionally, "deprival value" is measured as the lower of current replacement cost and recoverable amount. Recoverable amount is the higher of net realisable value and net present value of expected future cash flows arising from the continued use of the asset and subsequent disposal.

In applying the "deprival value" concept to the measurement of the physical non-current assets of government agencies, the general principle to adopt is that, if the agency would replace the service potential embodied in the asset if deprived of it, the asset should be measured at its **written-down current cost** (ie current market buying price, current replacement cost or current reproduction cost). Written-down current cost is appropriate because that is the amount which an agency would normally need to receive in compensation to restore it to its former capacity to meet its objectives by the acquisition of a replacement asset.

Where the service potential of an asset is dependent on its ability to generate net cash inflows, an agency's management would not rationally replace the service potential embodied in the asset if the net benefits expected to be derived from cash flows generated by the asset are less than the replacement cost of the service potential. Under the GTE asset valuation policy, those assets falling within this category are to be measured at the **lower of written-down current cost and recoverable amount.**

The service potential of most assets in the public sector is not considered to be dependent on their ability to generate net cash inflows because the agencies concerned are mandated by government/ministerial directives or legal/administrative requirements to continue to provide the services which the assets assist them to provide. Where such a requirement exists, the agencies would always replace the service potential embodied in the assets if deprived of them. These assets are to be measured at their written-down current cost.

The deprival value of an asset which is available for sale (eg a surplus asset) would be measured at its **current net market selling value,** irrespective of whether the asset had been deployed in profit-seeking or not-for-profit activities. Assets surplus to operational requirements are assets which are not currently utilized nor intended to be utilized in the foreseeable future by the entity and which are not integral to the operations of the entity.

The practical Guidelines set out in this document are consistent with the GTE asset valuation policy framework.

3. Valuation Methodology for Land Assets

The following methodology is to be adopted in valuing land assets:

(a) Where land is held for continued use and would be replaced if the agency was deprived of it, the basis of valuation under the deprival value concept is to be the greater of:

- **current market buying price**, taking into account the nature of the parcel, the legal restrictions on use, the opportunities for and impediments to development that are inherent to the specific parcel of land, other constraints that exist in respect of that land and any special attributes that the land may possess (**value in use**); and

The current market buying price is the current market value plus the buyer's transaction costs.

- **current market value** (selling price) based on its **feasible alternative use** taking account of the costs of achieving the alternative use.

As the feasible alternative use of land may be changed from one function to another (given time and resources), the Guidelines require the higher of value in use and current market value based on its feasible alternative taking account of the costs of achieving that potential. In considering the feasible alternatives, account is to be taken of the "highest and best use" of the property. The practical application of this concept must recognise the value (or impediment) of the improvements on the land - See definition in Section 9.

In the case of land assets which are held for the public benefit where there is no prospect of alternative use and where there are natural, legal and socio-politicial restrictions on use and disposal, eg. National Parks or Royal Botanical Gardens, it is inappropriate to have the asset valued on any basis other than ***value in use***.

"Value in Use" or "Existing Use" contemplates the continued use of an asset for the same application as at the date of valuation having regard to the asset's capacity to continue contributing to the objectives and value of the entity but ignoring alternative uses.

(b) Where land is held for continued use and the service potential would not be replaced if the agency was deprived of it, the basis of valuation is the greater of:

- **the net present value of future cash inflows; and**
- **current market value (selling price).**

> The net present value of future cash flows method is more appropriate where there is little or no market for a particular property but an income stream exists or can reasonably be expected.

(c) Land that is surplus to the current or anticipated needs of an agency is to be valued at **current market value (selling price).**

4. Practical Considerations in Land Valuation

The key principle in all real estate valuations is to determine the monetary price at which an asset would sell in open market trading among willing but not anxious parties who were all aware of the nature and potential of the property at the date of valuation. The essential elements are the knowledge of the relevant features of the assets and the understanding of the comparable property markets.

An important aspect in property valuations is the identification of all elements that would be taken into account by buyers and sellers in setting the price. Some of the basic elements include the land's description, area and/or dimensions, the legal or other interest of the agency, planning and other constraints on development, the availability of services, the potential for alternative use and physical impediments existing in the land.

It is recognised that often there will be no active market in the types of assets being valued because of the unique nature of those assets. It is, however, the task of the Valuer to establish appropriate value levels from market evidence of similar land types and to document the processes and assumptions used to arrive at such levels. Given that the aim is to obtain realistic assessments of agencies' land holdings, particularly those for which market values are not usually available, it is important to be able to show the rationale of those assessments. It is also necessary for the valuation reports to clearly state the methodology used to determine the values and to indicate that either all properties have been inspected and valued or a sampling process has been used to arrive at the figures.

The valuation of an asset for financial reporting purposes is not necessarily the same as the original acquisition cost to the agency. That cost might have represented the value to the vendor including development rights that no longer exist or improvements that have been removed. The valuation therefore should be based on the asset in its current use and condition.

The Guidelines do not require valuations to be made where the values cannot be measured reliably. Reliable measurement is one of the recognition criteria for "assets" as stipulated in Statement of Accounting Concepts SAC4 "Definition and Recognition of the Elements of Financial Statements". This is an important consideration in the approach to a number of types of land assets, such as land under roads where there is a predominant view that the existing valuation methodologies are not able to establish a reliable value of the asset to the responsible agency in most instances.

A major issue in land valuation in the public sector is the size of the holdings of some agencies. In some cases, it may be a question of providing a selection of benchmarks which are representative of the stock of land assets and making sufficient valuations to validly sample the whole portfolio. In other cases, such as the National Parks and Wildlife Service which has close to 5 million hectares of land, the difficulty is that the agencies concerned may have land located throughout the State in a large number and variety of holdings. In these circumstances, the opportunities for sampling are somewhat restricted and will only be available after a rigorous process of categorising holdings according to similar characteristics.

5. Specific Valuation Methods for Land Assets

Land Under Roads

The assessment of the value of public roadways poses problems to the Valuers. Public roads are provided for the benefit of the community and the funding required to maintain the asset comes from licence fees, Government grants, tolls etc. The assets are used by the public and the public have definite rights over the land, as distinct from a transmission line or pipeline which provides an agency with an exclusive means of reticulating a service, often over someone else's land by way of easement.

Roadways also provide a means of access for various utilities to reticulate services underground, eg gas, electricity, telephone etc. Because roadways provide the means of public access, they invariably enhance the value of adjoining land. Land without access has little value.

While it is agreed that land under roads is an asset, the Valuers consider that its value in use is difficult to measure accurately. The value of surplus roads which might be sold off for development is irrelevant. Land under surplus roads is assessed at market value based on highest and best use. The agency's interest in the road network is a balance of ownership and the obligation to maintain the network for the community, both generally and in respect of each party making specific use of it.

It is important to avoid capturing elements of value that are already reflected in adjoining property values by virtue of the existence of access roads and the whole road network. The proposition that the land under roads has a value similar to the adjacent land value or the average rateable value is invalid as it is tantamount to arguing that the land under roads has the same value as the land that it services and whose value it has enhanced. A further point is that no part of an operating road network can be "developed" to an alternative use without causing disruption to the road system and the community.

At present, according to most Valuers, there are no methodologies available that can measure reliably the value of the interest of an agency in the lands forming the basis for a public road network. To do so, the Valuer must be able to relate the valuations to the property market and to explain the processes by which they are obtained. This, in their view, cannot be done in the case of land under roads in most instances. Consequently, it is not appropriate for the value of these assets to be recognised for financial reporting. Instead, relevant information about the road network and the reasons for non-recognition should be disclosed by way of a note to the financial statements.

Land under Railway Tracks

Rail networks provide services including passenger and freight on a commercial basis and generally occupy land exclusively to do so. A railway, unlike a road system, does not provide access or services to owners of adjoining properties by right and it is important that valuations recognise this distinction.

Valuations of the land under rail networks exclude tracks and ancillary works, ie tunnels, embankments and cuttings. The land to be valued assumes, therefore, that the "surface" remains at its natural state that is the state existing prior to the construction of the works, ie before tunnelling, cutting or filling. This will be an important consideration in assessing value for rail corridors as the "natural" state of the land might have been an impediment to alternative development.

Typically, railways have large areas of goodsyards as integral parts of their operations. The "existing use" value of the goodsyards will generally relate to adjoining land values, especially where that is industrial in usage but care has to be taken to ensure that the railway land can be developed and serviced. It is often the case that goodsyards do not have access to water and sewerage reticulation sufficient for large scale redevelopment, or have other impediments to different use.

Examination of NSW railway corridors indicates that few sections in the metropolitan areas have potential for alternative use. Their value is best expressed as undeveloped adjoining land bearing in mind the limitations of access and serviceability. The main exceptions are those areas of railway land near retail centres where adjoining commercial values could be appropriate, subject to establishing the extent of the ability to provide "services" (eg water, electricity etc) to the land.

Generally, the value of railway lands in rural areas will be adjoining land values. Where a railway line is "disused", and would not as a consequence be replaced, it is to be valued at the greater of current market value (selling price) and the present value of future net cash inflows. In practical terms, the value will be related to current adjoining land values given the absence of anticipated cash flows from disused lines.

As an example, a section of railway 135 km. long between the metropolitan area and a country centre passes through 15 km. of residential areas with 4 suburban stations, one with a 4 hectare goodsyard, 90 km of mixed farming land and 20 km of national Park, then into the country town through the industrial area to the retail centre. Records and inspections confirm that the only locations where the line is wide enough to permit redevelopment are at the goodsyard, one suburban station and the country retail centre.

The following values are based on analysis of the sales of comparable properties along this route:-

90 km)	@ average	Rural	180 ha	@	$400	72,000
20 km)		National Park	40 ha	@	$75	3,000
15 km)	20m	Urban	30 ha	@	$30,000	900,000
10 km)	wide	Country	20 ha	@	$7,500	150,000
		Goodsyard (potential Industrial)	4 ha	@	$60,000	240,000
		Retail (suburban site)	2000m²	@	$80	160,000
		Country	1000m²	@	$60	60,000
						$1,585,000

The total value of this section of land under the railway is $1,585,000 which equals $11,740 per km overall.

Land under Transmission Lines and Pipelines

Transmission line easements provide a tangible service to commercial clients. They traverse all types of land use of varying levels of value. The value of the land within these easements should be assessed having regard to the value of the land traversed with an appropriate discount being made to reflect the extent of interest held, ie an interest less than freehold that represents the value to the agency of its right to the whole of the transmission line easement. As the line is an interest in land limited to transmission, the value is measured by the extent of disruption to the use of properties that it traverses. It is important to note that it is the value to the agency of the whole transmission line that has to be established, not the disruption to individual property owners by virtue of aesthetic or other considerations.

A similar method would be applicable to the valuation of land for pipelines where the interest held is by way of easement. Allowances made for the disruptive effect of the pipeline may vary, depending on the physical nature of the pipeline and whether it is above or below ground.

Freehold land for pipelines is to be assessed having regard to the existing use value taking into account the specialised nature and shape of the “corridor”.

The following is an illustrative example of the valuation of a transmission line 250 km long, 40m wide with towers every 100m traversing the following land uses:

3 km of industrial land (metropolitan)
5 km of open space land (metropolitan)
2 km of residential land (metropolitan)
30 km of rural homesites
100 km of farming land
80 km of grazing land
30 km of farming land adjoining a provincial city

		Discount Factor		
12	ha Industrial Land	@ 30%	of $150,000 per ha	$ 540,000
20	ha Urban Open Space	@ 5%	of $80,000 per ha	$ 80,000
8	ha Residential Land	@ 80%	of $250,000 per ha	$1,600,000
120	ha Rural Homesite Land	@ 25%	of $40,000 per ha	$1,200,000
400	ha Farming Land	@ 10%	of $5,000 per ha	$ 200,000
320	ha Grazing Land	@ 5%	of $500 per ha	$ 8,000
120	ha Farming Land	@ 10%	of $1,500 per ha	$ 18,000
1000 ha				$3,646,000

The rates per hectare adopted for the various land use types reflect the comparable values for those particular land classifications in the commensurate state of development as the lands traversed.

The discount applied in this example is the Valuer's opinion having regard to the level of disruption imposed by the easement to the freehold of the land. For example, an easement traversing a large grazing property is likely to have a minimal effect on value compared to an easement over residential land.

Land under Special Purpose Buildings

The following examples show the valuation approaches that are to be applied to assess the values of land under hospitals and schools. The same approaches can be adopted for Court Houses, Prisons and other similar facilities.

1. The site of an inner suburban hospital. As an example, assume a parcel of land of about 2.5 hectares with frontage to a main road and access to side or rear streets. Old hospital buildings are erected on the site. All the usual utility services are available to the site and the property. While zoned for a hospital, the land is surrounded by residential development with some potential for commercial/retail uses on the main road.

   The land value will be the greater of existing and feasible alternative use.

Value at "Existing Use" (land only)

Value of 2.5 hectares @ $1,300,000 per hectare based on analysis of sales of private hospital sites. **$3,250,000**

Value of "Feasible Alternative" say -

48 Town House sites - and	48 @ $65,000	
2,000 square metres of commercial land	2,000 @ $275/sq m	
		3,670,000
Less cost of site remediation	225,000	
approvals, rezoning	140,000	
services, Council contributions	205,000	
		570,000
Net Value		**$3,100,000**

The existing use value of the site is greater and the amount of $3,250,000 is adopted as the value in accordance with the Guidelines.

2. The site of an outer suburban school. As an example, assume a parcel of about 4 hectares located in a modern residential development on which is erected a ten year old secondary school with playing fields, hall/gymnasium etc. The site is level land, with the playing areas at the rear, access to a busy road and the usual utility services. It is zoned for a school and alternative potential would be limited to 50% residential as the rear land is too low to be serviced and built on.

Value at "Existing Use" (land only)

4 hectares @ $325,000 per hectare based on analysis of "en-globo" land sales in the district, which have a range of potential uses including long term residential but currently zoned "non-urban" - **$1,300,000**

Value of "Feasible Alternative" say -

20 homesites and 2 hectares of open space			
20 sites @ $100,000			
2 hectares @ $40,000			2,080,000
Less Subdivision development costs			
• Roads constructions	)		
• Water and Sewerage	) 300,000		
• Selling and Holding	145,000		
• Profit and Risk Factors	245,000		690,000
		Net Value	**$1,390,000**

The feasible alternative use value is greater and the amount of $1,390,000 is adopted in accordance with the Guidelines.

Land under Power Stations, Gas Works etc.

These days, power stations are constructed close to coal mines, adjacent to water supplies adequate for cooling and generally the locations are dictated by environmental, employment and other considerations. As a result, the stations are normally constructed on substantial areas of rural lands. This is in contrast to the earlier practice that had power stations and gas works built in cities at the ports where coal could be delivered by sea or rail and which were adjacent to workforce living areas.

Conventional valuation principles apply to the land under these types of infrastructure developments. The value of power station sites would usually be comparable to similar, adjoining rural properties, as long as care is taken to factor in the premium normally paid in the market for land around infrastructure projects and account is taken of the value to the power station of an assured water supply. Any premium will reflect the added value of securing the full control of surrounding land. Generally, the resulting valuation will be greater than "rural value".

Gasworks sites are usually located in or near industrial centres but, while "industrial" values will be relevant, care will have to be taken to identify problems of feasible alternative use. For example, a large gasworks site might be located on an isolated riverfront headland with only limited access or utility services potential. It could be incapable of economic redevelopment for alternative industrial uses, and too heavily contaminated for residential use. The alternative might then be limited to open space. This would ensure a valuation as a large industrial parcel with only a restricted range of options. Similar problems will exist wherever old style operations related to utility service generation continue to affect the use and value of the sites.

Land under Parliament House, Government House and Historic Houses

The site of Parliament House is of a CBD site with restricted potential. The restrictions relate to the existing buildings, and account will have to be taken of any requirements for maintenance of heritage items. In practice, the development potential of the land cannot be replicated in the market and the valuation must be limited to assessing the value of a site that is in that specific location, has that area of commercial building erected thereon and the ancillary service features. The main market evidence that will assist in arriving at a valuation will be "unaffected" CBD land sites that have been sold with heritage or similar constraints.

The site of Government House in the City is to be valued similarly, ie as a residential site possessing all the attributes that it has but limited by the restrictions, if any, on use of the site and the requirement to preserve the improvements. The most comparable market evidence will be found in Sydney's premier residential suburbs with valuation judgements necessarily being made to account for limits on redevelopment potential that might exist in the free market.

The values of the sites of historic houses will be established as residential values in the areas that they are located subject to the restrictions imposed by the existence of the buildings and Heritage Orders. The main effect of such restrictions will be to eliminate redevelopment potential and will ensure that the valuation is related to the extent of the protected use. As an example, the value of the site of a large heritage listed house will exclude any development potential that might have occurred if the property was in private ownership. This is because the purpose of the Heritage Order is to protect the property from that development and, in doing so, the potential no longer exists.

All government properties (which do not have a formal protection) should be valued in the same way as historic houses if it is expected that an Heritage Order would be imposed on them in the event that they were to be sold.

National Parks and Reserves

The aggregate of land owned or controlled as National Parks and Reserves in NSW exceeds 5 million hectares and represents a significant cross-section of all types of land in the State. Generally these lands are held in substantial parcels, often relatively unimproved or wilderness areas with no prospects of alternative use because of the natural, legal or administrative controls on the lands.

National Parks comprising large holdings outside cities or urban centres will be valued relative to adjoining similar lands with account taken of the state of land improvement (particularly clearing) and statutory or planning controls on subdivision or use. Consequently, a National Park in the Western Division of the State could have a land value similar to surrounding grazing properties. A Wilderness Area near a coastal urban centre, however, would be valued using evidence of markets for unimproved rural retreats, taking care to establish the relevance of building and other development rights.

The valuation of Parks and Reserves in urban areas can also be established in terms of the market values of comparable lands as long as care is taken to identify and account for any restrictions and circumstances peculiar to the land being valued. In many cases, a National Park reserve will have similar rights of use as a local park, i.e., public recreation limited by the protection of the environment. A bushland reserve would thus have a valuation based on the market for land that cannot be developed, further restricted by statutory duties, if any, imposed on the Parks Service.

The values of parkland in urban areas are not normally related to the values of adjacent developed land. Generally, there are sufficient instances of sales of land for recreation, open space or similar purposes to establish a framework and allow valid comparisons to be made.

For example, the land in a Western Division Park can be valued at a rate per unit (per ha., or per sheep area) relative to adjoining comparable rural properties but taking care to exclude any element of development potential, such as irrigation potential, that is not available to the agency. The same principle applies for a National Park on the Coast. Any potential, say for tourist development, has to be excluded despite the fact that the acquisition of the land would have cost the agency a price that compensated the former owner for any potential that then existed. This is because the asset is now to be valued as in the control of the agency subject to its current restrictions. Urban sites are treated the same except that any valuation must take account of the existing development potential and not impute any that does not and cannot be carried out.

Land in Water Catchment Areas.

The valuation principles applying are the same as for National Parks. In many cases, the controls in catchment areas are less restrictive and may permit uses such as grazing and rural dwellings. Consequently, values will be more closely aligned to the rural market. Most catchments cover very large areas and the valuation should reflect the size of the total holding, the limitations on development and the purpose of the controlling agency. That part of the Catchment that is surface degraded, because it is underwater, should not be discounted in value. It will form a small proportion of the whole and is an inevitable result of the process of construction of the works.

Crown Lands

Crown land is a valuable resource used by many government agencies to achieve their objectives. It should be recognised in the financial statements of those agencies which have "control" over its service potential and future economic benefits.

For the purposes of the Guidelines, Crown land is defined as all land held by government agencies which remains unalienated from the Crown and for which there is no title. It should be treated as any other asset controlled by government agencies. There are a number of categories of Crown land.

Vacant Crown land, such as large isolated rural parcels, should be valued in the same way as National Parks and catchment areas. Care must be taken to consider the possibility of claims being made and sustained under Native Title legislation.

Crown Land that is designated for development and disposal is to be valued at current market value (selling price).

Crown Land that is subject to perpetual leases, Western Lands leases etc., (including leases where there is a statutory right to buy the freehold) is to be valued at the present value of net cash flows received under the leases. The same principles apply here as would in any valuation where the interest was less than freehold. The value to be determined must reflect the extent of the interest of the agency in the asset.

Where appropriate, a note should be included in the financial statements indicating the nature and extent of restrictions placed on the use and disposal of the land.

Parks and Botanical Gardens

As stated earlier, there is generally an active market in land for recreation, open space and similar purposes. This can be utilised to assess values in parklands as long as care is taken to isolate factors such as development potential in the prices being paid in the market when the parks are subject to the usual controls on use. It is important to recognise that the values of adjoining lands are based on different criteria and potential and are consequently not to be taken as setting park values.

Notwithstanding the scientific, cultural and heritage considerations usually associated with Botanic Gardens, and their location in the centre of the CBD, the land value of a Botanic Gardens site is to be determined consistently with other parks. The same applies to large urban parcels such as Sydney's Centennial Park and Moore Park.

6. Valuation Methodology for Heritage Assets

Heritage assets are those assets which a government has decided to preserve for the duration of their physical lives because of their unique historical, geographical, cultural and/or environmental attributes. It is recognised that some heritage assets are of a solely historical or cultural interest (for example, monuments and statues) while others also provide a functional service.

Under the Guidelines, heritage assets are to be valued consistently with the valuation policies to be applied to other physical non-current assets of an agency.

Where the service potential embodied in a heritage asset would be replaced if the agency was deprived of the asset, the value of the asset is the **written-down current cost** of the service potential.

Where heritage assets are viewed as having both functional as well as heritage characteristics (eg heritage buildings), the value of the heritage or aesthetic utility component may be difficult to be reliably measured. Such component is not required to be identified and valued for financial reporting purposes. It is, in effect, excluded from the asset value disclosed in the financial statements. However, additional information on the heritage features and the annual maintenance/preservation costs should be included in the notes to the financial statements.

Where the service potential of the asset would not (or cannot) be replaced were the agency to be deprived of it, the asset should be valued at its **recoverable amount**, which normally will be its **market value (selling price)**. Some heritage assets are irreplaceable because of their unique nature.

There will be instances where a heritage asset will not be recognised in the financial statements. This will occur where the selling price cannot be reliably measured (eg where there are no markets for comparable assets) or there are no cash flows associated with the heritage asset. A decision not to value certain heritage assets because of difficulty of measurement would need to be supported by an internal or external opinion given by an expert in that particular area.

Where the values cannot be measured reliably, the assets are to be excluded from the balance sheet. Examples are historic library and museum collections, historical treasures and unique works of art. Information in respect of these items, which is relevant for decision-making by the users of financial statements, should be disclosed in the notes to the financial statements. This information should include, for example, the quantum and the nature and functions of the assets together with the annual costs of maintenance/preservation where applicable.

7. Specific Valuation Methods for Library/Museum Collections and Works of Art

The initial basis for a valuation exercise will be the identification of the collections owned by the Institution and its categorisation. These processes will relate to the purposes of the Institution, eg., a Gallery of Australian Painting would have different criteria to a Museum of Technology.

If, say, an Art Gallery has identified and categorised its collection into artworks of specified periods, it can set about obtaining expert valuations. It should be possible to arrive at a reliable assessment of the value of the whole collection, either by individual valuations or by sampling. A typical program would include valuation of particular works which were unusual or valuable and assessing a part of the remainder internally each year on a rotating basis with random independent checks. The experience of the agency staff and management should assist in making decisions about the resources that need to be committed to this activity.

On the other hand, a Museum might have collections containing elements that range from the priceless through the valuable to the "difficult to measure" category. Examples could include the personal property of a colonial founder, an extensive philately collection and a scientific collection. The first cannot be valued by reliable measurement as it is unique; the second can be valued readily and the third can only be valued if there is a reliable measurement system that has been developed in the appropriate professional areas.

In many instances, the purpose is to bring together the collection items for storage, archiving or public exhibition. It is difficult to see how most of these items can be measured reliably. The costs and benefits of undertaking valuations in respect of large collections should be assessed by all agencies. Where the costs appear to far outweigh the benefits, the Treasury should be consulted with a view to obtaining an exemption from carrying out the valuation. However, it is expected that such exemptions will be uncommon and will only be granted following the receipt of comments from the Audit Office.

8. Sampling Approach

It may be appropriate to value samples of an agency's assets, rather than all assets individually, if it can be demonstrated that the results provide a fairly accurate measure of the value of the relevant asset base. For example, some agencies have within their portfolios a number of properties of the same type that could be grouped into specific categories and assessed by way of sampling, eg Department of Housing estates, Teacher Housing Authority housing, schools etc. The application of the benchmarking technique would depend on the degree of the comparability of the property within the agency's portfolio.

The benchmark properties selected should have similar characteristics and should follow a consistent trend in value movement. The following key points would need to be taken into account in applying the benchmarking approach to property assets:

- It would be necessary for all property within the portfolio to be categorised in the first instance.
- Benchmark properties would then be selected by the Valuer and they should be representative of as much of the characteristics of the portfolio as possible.
- Subsequent revisions of valuations would involve an assessment of the benchmarks by a Valuer and indexation of the various categories by a factor reflecting the fluctuation in the market between the prior valuation date and the reporting date.
- Any property that is unsuitable for benchmarking would need to be valued individually.
- Care would need to be taken to make adjustment for additional improvements, redevelopment, demolition, change of use etc.
- This method of assessment would only be suitable for a limited period and a formal review of each sample should be undertaken periodically to ensure it remains representative.

The main advantage of benchmarking is that valuation costs can be reduced considerably due to the much smaller number of items that have to be valued.

The benchmarking approach can be extended to large non-urban holdings, such as National Parks or catchment areas, where the extent of development of properties is generally known and the limitations imposed on use or development reduce or even eliminate feasible alternatives. In these situations, the process of valuation would be facilitated if inventories of improvements, property records, air photos etc., were readily available. The Valuer can then undertake the required number of valuations or sample parts of the property portfolio to provide the basis for assessing the values of the whole of the agency's asset.

9. Definitions

Value in Use (Market Value for Existing Use)

The following definition is from the "Guidance Notes and Background Papers on the Valuation of Fixed Assets for Financial Statements", issued by the International Asset Valuation Standards Committee (Background Paper C).

"Market value for existing use presupposes a continuance of the business and that the property will continue as owner occupied in its existing use. Thus any possible higher value related to an alternative use or element of hope value arising from the prospects of redevelopment and any possible increase in value due to special investment or financial transactions which would leave the undertaking with a different interest from the one which is to be valued, will be disregarded. Goodwill personal to the undertaking or its management, and transferable to other property, will also be ignored.

Market value for existing use does include the possibility for extensions or further buildings on undeveloped land or redevelopment of existing buildings, providing such construction works can be undertaken without major interruption to the continued business."

Feasible Alternative Use

The feasible alternative use should be a use which can demonstrably be achieved in the relatively near future (say the next five years) rather than some usage which could be achieved in the distant future. Account will need to be taken of the existing political and socio-economic environment within which the agency operates as well as the general and statutory zoning restrictions in respect of the land. The costs of achieving the feasible alternative use could include holding costs, the costs required for any rezoning of the land, the restoration or removal of existing infrastructure and/or reparation work to restore the land to a useable condition for that use. These costs are to be assessed in establishing the current market value (selling price) of the land's feasible alternative use.

Highest and Best Use

Recognition of the willing seller/willing buyer concept necessarily involves valuation for the highest and best use of the land. The prudent and well informed vendor (whose existence must be assumed) would not willingly part with his land for a price less than that appropriate to its highest and best use; and the prudent and well informed buyer would not expect to be able to purchase it for less. Each party would take into account "not only the present purpose to which the land is applied, but also any more beneficial purpose to which, in the course of events at no remote period, it may be applied, just as an owner might do if he were bargaining with a purchaser in the market. This is the mode in which the land would be valued" (said by Isaacs J in Spencer V the Commonwealth of Australia).

Reference: Land Valuation and Compensation in Australia, R.O Rost and H.G Collins

Market Value

"Market Value" is defined as the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arms length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. Market Value is based on the highest and best use of the asset which will not necessarily be the existing use.

APPENDIX FIVE:

Survey document: survey of public sector agencies -

implementation of accrual agencies in the NSW public sector

PUBLIC ACCOUNTS COMMITTEE OF NSW

IMPLEMENTATION OF ACCRUAL ACCOUNTING IN THE NEW SOUTH WALES PUBLIC SECTOR

SURVEY OF PUBLIC SECTOR AGENCIES

NAME:____

POSITION:____

ORGANISATION:_______________________________________

(The above information is voluntary. It will only be used, if necessary, by the researchers to clarify your answers and to ensure the accuracy of survey information.)

(IF YOU FIND THE SPACE ALLOCATED BELOW QUESTIONS INSUFFICIENT FOR YOUR ANSWERS, PLEASE ATTACH ADDITIONAL PAGES and REFERENCE THEM TO THE APPROPRIATE QUESTION)

ACCRUAL INFORMATION vs CASH BASED INFORMATION

Q1. Give specific examples of instances where accrual accounting *(as opposed to cash accounting)* has improved your financial or administrative management.

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Q2. How often, and why, would senior officers in your organisation still require cash based information?

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Q3. In what way(s) does your organisation receive the full benefits of accrual accounting and accrual based information ? **(Give both general impressions and specific examples).**

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IMPLEMENTATION TIMETABLE

Q4. In which year did you start implementing accrual accounting? ______________

Q5. Have you completed the implementation?

Yes ☐ No ☐ ***(go to Q 6)***

→ How long did it take you? (eg yrs, mths)

____

Q6. How far have you progressed in implementation to date? *(tick appropriate box)*

Less than 30%complete ☐

About 50% complete ☐

About 75% complete ☐

Other (please specify) ____________________

IMPLEMENTATION COSTS

Q7. Has your organisation been able to quantify the total cost of implementing accrual accounting?

Yes ☐ No ☐

→ Please provide, and justify, an estimate:

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→ (1)Please provide cost $____________________

(2)Please provide a cost summary:

Information Technology: $____________________

Human Resources: $____________________

Consultants: $____________________

Other: $____________________

Q8. In introducing accrual accounting, did you purchase computer equipment (hardware and software)?

Yes ☐ No ☐ *(go to Q10)*

Q9.Please indicate the cost of computerisation **directly attributable to the implementation of accrual accounting** within your organisation:

Hardware	$____________________
Software	$____________________
Staff training	$____________________
Systems development costs (eg consultants)	$____________________

Q10. Does your current computer accounting system satisfactorily meet your needs in respect of producing reliable accrual accounting information?

Yes ☐ No ☐

→ Please give details:

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INFORMATION SYSTEMS

Q11. Do you maintain your previous systems (eg cash-based) in addition to your accrual accounting systems?

Yes ☐ No ☐ *(go to Q13)*

Q12. What are these systems, why do you continue to maintain them, and how much extra per annum do you believe it costs to maintain both systems?

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Q13. Would you have updated your financial management information system if accrual accounting had not been introduced?

Yes ☐ No ☐

HUMAN RESOURCES

Q14. Before you introduced accrual accounting, how many financial/accounting staff did your organisation have? *(please complete the table)*

Quantity	(Base) Salary Range
	> $80 000
	70 000 - 80 000
	60 000 - 70 000
	50 000 - 60 000
	40 000 - 50 000
	30 000 - 40 000
	20 000 - 30 000

Q15. When you introduced accrual accounting, did you require additional permanent staff?

Yes ☐ No ☐ (go to Q16)

Give details of the additional staff:

Quantity	(Base) Salary Range
	> $80 000
	70 000 - 80 000
	60 000 - 70 000
	50 000 - 60 000
	40 000 - 50 000
	30 000 - 40 000
	20 000 - 30 000

Q16. What are your estimated costs in relation to staff training for the implementation of accrual accounting (eg seminars, courses, associated salary costs)?

$____

Q17. If you used consultants or external expertise in implementing accrual accounting, how much do you estimate this cost to be to your organisation?

$____

Q18. What competencies do you believe accounting staff should have in order to adequately handle accrual accounting and its associated reporting and information needs?

Q19. What was the attitude of existing staff towards the implementation of accrual accounting?

Q20. How well do you believe they coped with the new requirements (eg information, reporting, accounting) accrual accounting placed on them?

Q21. Were some staff retrenched or redeployed because of their inability to cope with the various changes resulting from the implementation of accrual accounting?

ASSET VALUATION

Q22. Asset valuation has been identified as one of the major tasks involved in implementing accrual accounting. How would you describe the accounting for assets in your organisation prior to the introduction of accrual accounting? (Give both general impressions and specific examples)

Q23. Please outline the process by which your organisation has identified its assets and valued them as part of the implementation of accrual accounting. (Give both general impressions and specific examples)

THE ROLE OF TREASURY

Q24. How would you describe the role of Treasury in the provision of funds to meet the costs of accrual accounting?

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Q25. Did Treasury at any time, organise training for your organisation on accrual accounting?

Yes ☐ No ☐

→ Was it appropriate? Y ☐ N ☐
→ Was it compulsory? Y ☐ N ☐
→ Is it ongoing? Y ☐ N ☐

Q26. What level of support (apart from training) did Treasury provide to your organisation, and is it ongoing?

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Q27. Did you encounter any problems with Treasury at any stage of the accrual accounting implementation process. Give general impressions and specific examples.

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Q28. How do you see the on-going role of Treasury in the formulation of accounting policy?

GENERAL ISSUES

Q29. Are there any other BENEFITS (other than those covered in Q1 and Q3) which accrual accounting has provided to your organisation? Please explain these benefits briefly. **(Give both general impressions and specific examples)**

Q30. Are there any other COSTS to your organisation (other than those covered in Q7, Q9, Q16 and Q17) which have occurred as the result of accrual accounting. Please explain these costs briefly. **(Give both general impressions and specific examples).**

Q31. Do you believe your organisation has received value for money from the implementation of accrual accounting? **Please provide reasons.**

Q32. What are 5 current public sector accounting issues which have arisen in your organisation as the result of the introduction of accrual accounting, and how have they been addressed, if at all.

Issue #1

Issue #2

Issue #3

Issue #4

Issue #5

Q33. Please provide any additional comments on aspects of the accrual accounting implementation process which you feel have not been covered by this survey.

END OF SURVEY. THANK YOU FOR YOUR TIME

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