

# **Adoption of the Government Financial Statistics Accounting System by Australian Governments**

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Adoption of accrual accounting was one of the most significant reforms undertaken by the Australian public sector in the 1990's, but it resulted in much controversy concerning the relevance of the Australian Accounting Standards (AAS) based system for the public sector. When cash accounting and budgeting systems were discontinued by the Commonwealth Government in 1999 in favour of accrual budgeting, the Government introduced two accrual budgeting systems – the AAS budgets and another set of budgets based on the Government Finance Statistics (GFS) accounting system. However the GFS system was unknown to the profession and to most public servants outside the Treasury and Finance Departments.

The two systems reported substantially different figures for most budget items, resulting in much confusion in Parliament and questions as to which set of budgets should be believed. Several Senate Committee hearings considered the issues but were unable to resolve them. The Financial Reporting Council issued an “urgent directive” to the Australian Accounting Standards Board (AASB) to “harmonise” the two systems into a single one in December 2002. Further confusion was caused by confining the GFS budgets to the whole of the General Government Sector (GGS) and to aggregate agency budgets, while agencies kept their accounts using the AAS system and prepared only AAS outcome financial statements.

This prevented reliable comparisons being made between the budgets and the outcomes. As well, the audited financial statements of the Government covered the AAS reports of each department and the consolidated reports for the whole-of-

government including its financial and non financial corporations, but they did not report on the GGS as a separate entity.

The AASB responded to the FRC harmonisation directive with the release of a new standard, AASB1049, in October 2007, which made some significant changes to its public sector standards, but not the fundamental ones required. The incoming Government in 2008 commissioned the *Operation Sunlight Report* to examine the budget reporting systems and to recommend changes which would enhance their transparency to Parliament and the accountability of the Government. Most of the recommendations in the Report, finalised in June, were accepted by the Government in December 2008. However the Government presented the 2008-09 budgets to Parliament in May using only an enhanced GFS system which incorporated some acceptable parts of the AASB1049 standard, and the AAS budgets were discontinued.<sup>1</sup>

These issues are examined in the Lecture. I believe the Government made the correct decision to adopt the enhanced GFS system in preference to the AAS one and to discontinue the latter. The GFS system provides the accounting information required for both fiscal policy management and resource management purposes, and for the better transparency and accountability of Government operations to Parliament and the public. However, further progress is still required to align budgets across all tiers of operations, direct reporting of cash only transactions to Treasury and Finance, and adoption of GFS outcome financial statements by departments and the whole of the GGS to enable the making of budget/actual comparisons, along with the audit of these outcome financial reports.

To justify the adoption of the enhanced GFS accounting system by the Government (and consequently by all state governments), the following matters are covered for

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<sup>1</sup> I prefer to describe the modified GFS system as the enhanced GFS system rather than the harmonised system as the extent of harmonisation was rather limited.

the public sector and compared with those for business and the AAS accounting system:

- i) The nature, purpose and operating environments of governments are explained and then briefly compared with those of business.
- ii) The framework for derivation of the financial information required on cash transactions and on all external transactions, and the financial performance and financial position of the entity, for both governments and business. The framework is based on a normal analytical methodology in order to identify causal relationships in the data.
- iii) An explanation and analysis of the enhanced GFS system, along with brief comparisons with the AAS system.
- iv) An evaluation of the GFS system as the appropriate one for government use.
- v) Conclusions and some unfinished business for the GFS system.

## **NATURE, PURPOSE AND OPERATING ENVIRONMENTS OF GOVERNMENT**

Governments are elected by citizens to manage the affairs of the nation as a whole to provide those goods and services which cannot readily be provided by business firms. They act as agents of citizens and are accountable to them for their actions and performance. US President Abraham Lincoln (1863, p282) summed up their responsibilities many years ago as:

“The legitimate object of government is to do for a community of people whatever they need to have done, but cannot do at all, or cannot do so well, for themselves in their individual capacities.”

This notion is captured in the specification of the roles of government in the International Monetary Fund (IMF) *Government Finance Statistics Manual* (2001) which is quoted in the Australian Government’s Budget Paper No 1 each year as:

“... the provision of public services that are mainly non-market in nature, and for the collective consumption of the community, or involve

the transfer or redistribution of income. The services are largely funded through taxation and other compulsory levies (BP1, p9.13, May 2010).”

Non-market public goods and services cover items such as the provision of law, order and regulations; foreign policies; defence of the nation; public roads and lighting; recreational facilities for citizens such as parks, gardens and sports grounds; cultural facilities such as art galleries, museums, war memorials and libraries; environmental protection of the landscape, rivers, beaches and native forests; and so on. In addition, a large proportion of health (hospital and medical services) and education services (schools and universities) are provided for public use. Use of these services is shared by citizens and all citizens have the right to share in their use. But they do not own the facilities nor have exclusive rights of use.

Governments need to provide these non-market goods and services because, with a few partial exceptions, they cannot be provided by private firms because of their non-rival and non-excludable characteristics (Musgrave 1988, Chaps 1-4, Stiglitz 3<sup>rd</sup> ed 2000, Chaps 7 & 8). In economics, they are referred to as public goods. Their use is non-rival as one citizen’s use of them does not prevent other citizens from using or benefitting from their provision. Their use is non-excludable as no one citizen can prevent others from using them. Public goods are provided to the community generally and are often called community goods and services. Citizens share in their use and cannot own them or prevent other citizens using them.

With a few partial exceptions such as for personal health, medical and educational services (known as mixed public-private goods), community goods and services cannot be provided by private firms because they cannot *sell* the services to users who require ownership possession and use rights. Why would someone voluntarily purchase them where they can be freely obtained as a public good (the free-rider problem)? Moreover, most of the services involve large infrastructure costs in providing the facilities, while their direct marginal use costs are often low. This feature also deters their private provision.

The nature of public goods and services can also be explained in terms of the economic concept of *externalities*. Externalities occur wherever private costs and benefits do not coincide with the total costs and benefits to *society*. They are often flow-on effects from the initial transaction or use of the item. The externalities may be negative, for example from private pollution or global warming caused by human activity, or the generation of asset price bubbles on financial markets and their subsequent crashes causing business bankruptcy, unemployment and recession as occurred following the 2008 Global Financial Crisis. Alternatively, they may be positive such as those flowing from improved education and health standards in the community, and cultural and recreational facilities which increase the general welfare of the nation. As well, they often increase the productivity of the nation.

Hence where goods and services required by the community have the characteristics of non-rival and non-excludable use which can give rise to positive externalities, it is more efficient and effective for governments to provide them on a collective, shared-use basis, and likewise for citizens to fund them on this basis through taxation. This is in accordance with Abraham Lincoln's observation of 1863, and the IMF's prescription of one of the core roles of governments. They cannot readily be provided by private firms. On the other hand, negative externalities are normally controlled through government regulation and taxes.

The second core role of government involves the transfer or redistribution of wealth. This is achieved through the provision of social welfare services to disadvantaged citizens for social equity purposes, and secondly, through the design of the taxation system. Social welfare benefits are provided, for example, to elderly, disabled and unemployed citizens. Private firms have no obligations to provide these benefits, and citizens want them to be provided by their governments.

The taxation system which funds government provision of its non-market and social welfare obligations normally involves progressive income tax scales and capital gains taxes, as these tax wealthier citizens much more heavily. As well, many other sources of taxation are used such as company taxes and expenditure taxes.

Following the Great Depression of the 1930s and many reviews of government operations in the 1980s-90s, the above basic functions of governments have been broadened to emphasize several areas of community responsibilities listed below. Governments now aim to manage their fiscal policies to achieve the following additional objectives:

- i) Sound macroeconomic management of the nation to ensure stable, sustainable economic growth with high employment and low inflation;
- ii) An equitable distribution of income and wealth across the nation's citizens;
- iii) Maintenance of intergenerational equity;
- iv) Protection and conservation of the natural environment;
- v) Protection, conservation and promotion of the nation's cultural facilities.

As well, recent public sector reforms have emphasised that governments must manage their resources more efficiently and effectively than in the past in providing their community services and for greater accountability to parliament and the public.

i) Sound macroeconomic management. Free market economies through history have undergone cycles of boom and recession and their resultant serious unemployment, business bankruptcy and poverty, and government budget deficits and debt. The current Global Financial Crisis (GFC) is a sad example of this. (Garnaut 2009, Stiglitz 2010, Budget Paper No 1 Statements 1 – 3 May 2010). Government fiscal policies can be designed, in conjunction with monetary and other economic policies, to bring about stable and sustained economic growth with full employment and low inflation. Australia did this throughout the 1950s and 1960s, and to a lesser extent from the late 1990s until the GFC exploded in September 2008, by applying Keynesian macroeconomic management policies (1936). Keynes developed the

policies following the Great Depression of the 1930s. The size of the operating budget balance (deficit or surplus) and capital expenditures on new infrastructure, which affect the aggregate demand and supply variables in the nation, are key drivers of good macroeconomic management. They are also important for intergenerational equity considerations.

ii) An equitable distribution of income and wealth across society. Free market economies inevitably result in gross maldistribution of income and wealth with a small wealthy class and a large group of low income residents. Progressive income tax scales and capital gains taxes help to reduce the inequalities along with the integrity of the tax system (i.e. minimisation of tax avoidance opportunities). Societies are invariably happier in nations having a reasonably equitable distribution of wealth and income (e.g. Norway and Australia, *UN Report 2010*).

iii) Maintenance of intergenerational equity. The aging of the population and the mounting levels of government debt caused by budget deficits and unfunded liabilities (e.g., for staff superannuation) impact on future generations of citizens. They will be required to pay for the costs incurred by governments in their service provision to past citizens, in addition to funding their own service provision. For equity purposes, each generation should fund the collection of services it receives and enjoys. As well, maintenance of the nation's natural and cultural environments and public infrastructure facilities are important contributors to achieving intergenerational equity. Intergenerational reports covering the coming forty years are now prepared on a projected cash flow basis each three years to show the long term effects of these factors on future budgets (Australian Government, *Intergenerational Report*, Jan 2010).

iv) Protection and conservation of the natural environment. Life depends on the whole ecosystem, i.e., the natural environment, and it requires government protection because it can be treated as a 'free good' by firms and people when they incur no

charges for its use. Pollution of land, rivers, water catchment areas, coastlines and seas, deforestation, soil erosion from poor farming practices and so on are negative externalities which have damaging environmental impacts. Global warming caused by pollution of the atmosphere from excessive emission of greenhouse gases by industry and people is now regarded as the most serious problem facing Planet Earth and the future of mankind. Government regulatory and taxation policies are needed to protect the natural environment.

v) Management of the nation's cultural environment. Citizens like to be proud of their history and culture. Free or low-cost access to public art galleries, museums, recreational and sporting facilities, etc, produce positive externalities through enhanced national pride, education, personal health and so on. Citizens expect governments to protect, conserve, enhance and promote the facilities through government expenditure on them.

vi) Efficient management of the government's own resources. This important role only came to be emphasized during the many recent reviews of government operations. In 2009-10 the Government had revenues \$294 billion, operating costs \$343 billion, assets \$318 billion, liabilities \$338 billion, and net worth -\$20 billion (*BPI, May 2010*, pp 9.3, 9.4. Figures are the estimates for 30 June 2010). Total tax revenues and operating expenditures reallocate a substantial volume of resources (about 25% of GDP) from the private to the public sectors and together with its large volume of assets and liabilities, the Government is by far the largest economic entity in Australia. Its resources include all of these items, and it is imperative that they be managed efficiently and effectively in the provision of public services. Good management reduces both operating and investment costs, thereby releasing funds for additional service provision, tax cuts or enhanced net worth. Their good management requires use of a quality cash and accrual Financial Management and Information Reporting System (FMIRS). It also enhances government accountability to parliament and citizens for its performance in service provision. Prior to the adoption

of accrual accounting systems by the Government in the early 1990's, only cash accounting systems were used. Not only were all the other resources not included in financial reports, but they were largely ignored for management purposes. Thus excessive operating costs were incurred, many physical assets were poorly maintained or surplus to requirements, and liabilities were not given adequate attention, control and funding.

Thus from the above explanation of government operations, it is evident that they are complex ones having multiple and interrelated objectives. They are fundamentally different from those of business firms. This fact must be recognised in the design of an FMIRS which recognises the true nature, operating environment and functions of governments in providing their services to the community in such a complex environment. If they were not so different, then there would not be a strong justification for their government provision, and governments might only be left with responsibility for law and regulatory functions, defence and foreign policy.

## **FRAMEWORK FOR FINANCIAL MANAGEMENT INFORMATION AND REPORTING SYSTEMS**

Having explained the nature and purposes of government operations, the next step is to establish the framework for the design and content of the FMIRS which reports the information required by users. A normative, analytical methodology enables causal relationships between the data and user information requirements to be established. This requires that the objectives of the FMIRS are specified in broad terms, such as to satisfy policy making, resource decision making and management purposes, operating performance measurement, financial position measurement, and for discharging accountability responsibilities of management to external stakeholders. Such information should be relevant, reliable and understandable, and enable comparisons with like information over time and between similar entities (AASB

*Framework, 2004*). Likewise, the operating environment of the entity must be explained to ensure relevance of the information.

The framework for the development of an FMIRS is illustrated below.

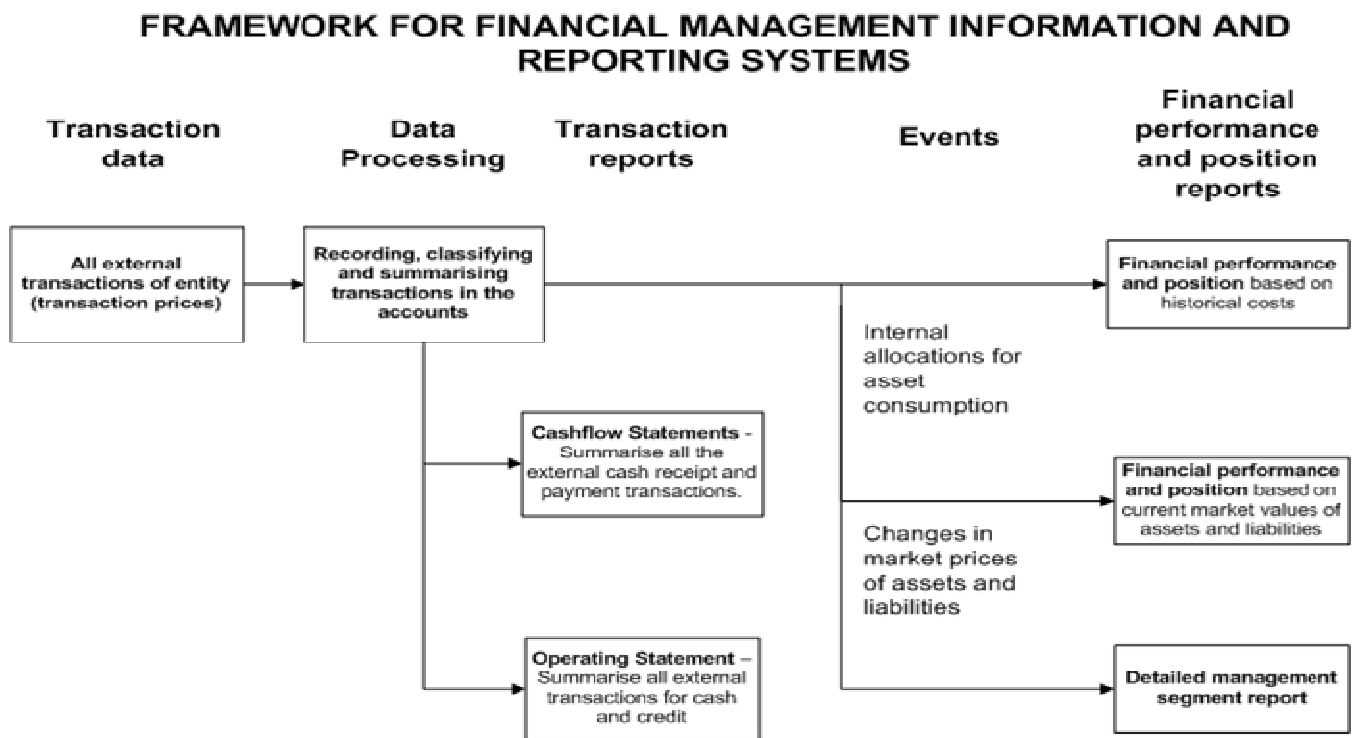


Figure 1. Framework for FMIRS. (Barton 1982, p.46)

The framework begins with the recording of all external transactions of the entity and their classification and entry into relevant accounts. Two financial statements summarising the transactions can be prepared, one for cash (the cash flow statement) and the other for all cash and credit items (the operating statement). Each can be classified between operating, financial and capital items. The statements ignore all non-transaction events such as use of the entity's own resources (e.g.. depreciation), changes in market prices of assets and liabilities, and internal allocations of costs and revenues between departments of the entity.

The next step of measuring and reporting on financial performance and position of the entity involves including the effects of non-transaction events mentioned above. However this requires the development of a conceptual framework to determine precisely what information is to be reported and how it is to be measured, and is illustrated in Figure 2 below.

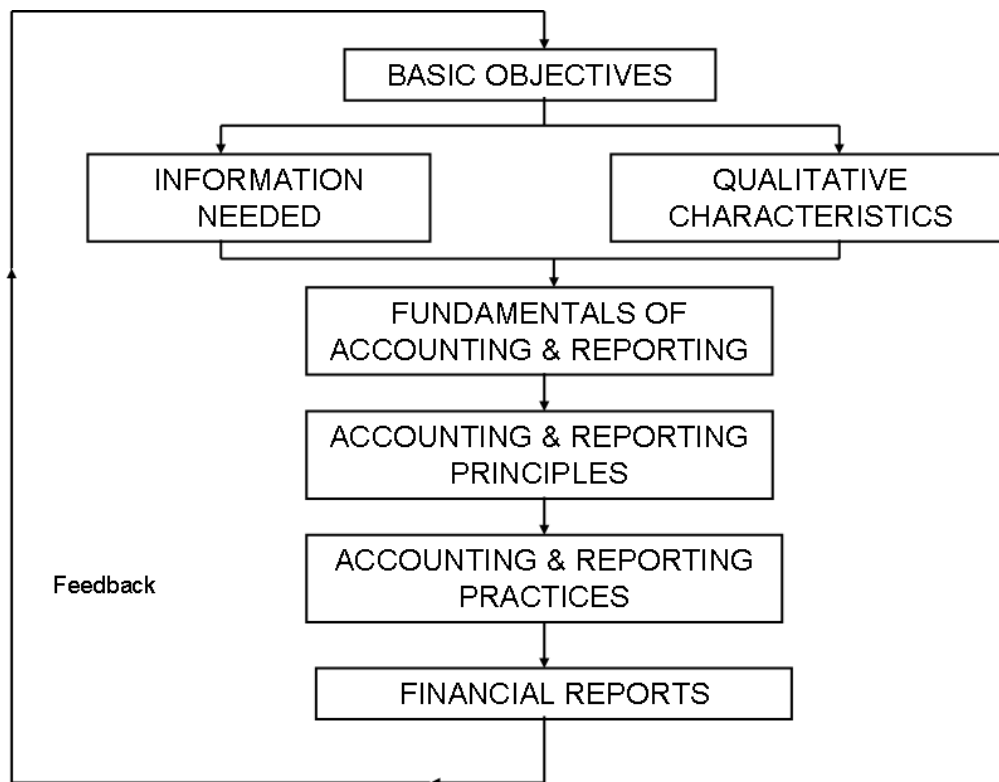


Figure 2. Conceptual framework for accounting and reporting (Barton 1984, p. 19)

The Conceptual Framework requires specification of the broad objectives for which the information is required (eg, for resource use decision making), the information required to meet these purposes (eg, profit) and the standards for good quality information (eg, relevance). Next, the fundamental accounting concepts (eg, profit) and their measurement (eg, bases of asset valuation) need to be specified and the practices derived (eg, methods of depreciation) for the measurement of the required information for the financial reports. The information reported should then be checked against its specified objectives to assess whether it has achieved them. If not, the system must be reviewed and modified to correct its deficiencies.

All the key accounting concepts of financial performance comprising revenue, expenses, gains and losses, income, and so on must be defined and likewise financial position and its constituents of assets, liabilities and equity or net worth.

The basis of asset and liability valuation must be specified because it affects the measurement of costs of using assets and hence profit in business or net operating results in government, as well as the financial position of the entity. The two major bases of valuation comprise historical transaction prices or current market prices. Each normally causes significant differences in the results reported. Finally, detailed reports on each segment of operations can be measured and reported for management purposes.

## **THE GOVERNMENT FINANCE STATISTICS ACCOUNTING SYSTEM**

### **a) Some History**

The GFS accounting system was initially developed in the early 1980's for the measurement of Gross Domestic Product, National Income and all other key economic measures of a nation's financial performance. However it was confined to cash transactions only. It was adopted by the International Monetary Fund and used by most nations for GDP measurement purposes. It enabled relevant, reliable and understandable measures of key macroeconomic variables which were comparable across nations. The system was developed by Professor Sir Richard Stone of Cambridge University in England who was awarded the Nobel Prize in Economics for its development. In the late 1990's, the system was upgraded to a full accrual accounting system by several government statistical agencies, including the Australian Bureau of Statistics, for the IMF; however it retained direct reporting of all external transactions.

The purpose of the expanded GFS system is "to provide a comprehensive conceptual and accounting framework suitable for analysing and evaluating fiscal policy,

especially the performance of the general government sector and the broader public sector of any country” (*IMF Manual* 2001, pp 1.2 – 1.4). Unfortunately the statement fails to mention that the expanded accrual GFS system can also be used for the measurement and management of all government resources. Only a few governments (including Australian) acknowledged this responsibility at the time.

The Australian Treasury implemented the revised GFS system for the 1999 accrual budget when it was required by the Government to adopt accrual budgeting, as it found the AAS accrual budgets could not report the key measures required for fiscal policy development and monitoring, and for cash management. A major advantage of the GFS system is that it can report both cash and accrual results concurrently, and hence cash budgeting can continue alongside accrual budgeting.

However, the reporting of two sets of accrual budgets, along with their cash counterparts, caused major confusion in the Parliament as each set reported substantially different results, as illustrated in the major aggregates for each of the four sets of budgets reported in Tables 1 and 2 below (Barton 2007, pp. 42 and 43). 2006-07 was the last time that both AAS and GFS budgets were reported<sup>2</sup>.

<b>Table 1: GFS and AAS Cashflow Budgets 2006/2007</b>			
	<b>GFS \$m</b>	<b>AAS \$m</b>	<b>Difference \$m</b>
Cash receipts from operating accounts	266,582	232,048	34,534
Cash payments for operating accounts	250,623	211,003	39,620
Net CFs from operating accounts	15,959	21,045	-5,086
Net purchases of assets	15,897	20,804	-4,097
Net debt repayment	604	784	-180
Net reduction in cash balance	543	543	-

Source: *Budget Paper No. 1, 2006/07, Statement 9:7, Statement 10:8*

<sup>2</sup> The differences between the GFS and AAS figures in recent years were larger than the above, but progressive amendments to the GFS treatments narrowed them.

<b>Table 2: Comparison of GFS and AAS Accrual Budgets 2006/2007</b>			
	<b>GFS \$m</b>	<b>AAS \$m</b>	<b>Difference \$m</b>
<b>Operating statements</b>			
Total revenues	271,662	233,597	38,065
Total expenses	259,080	221,101	37979
Net operating results	12,583	12,496	87
<b>Balance sheets</b>			
Financial assets	150,148	138,472	11,676
Non-financial assets	45,493	82,641	-37,148
Total assets	195,641	221,113	-25,472
Liabilities	205,035	204,580	455
Net worth	-9,394	16,533	25,927

*Source: Budget Paper No. 1, 2006/07, Statement 9:5-6, Statement 10:3-4*

Parliament is required to debate and approve the budgets before they can be implemented. Which budget did Parliament approve? Furthermore, the cash appropriations to departments are based on the “approved” budget. No wonder that Parliament was confused! As well, the AASB was concerned that another accounting system, unknown to it, had been adopted as well.

Controversy over the choice of budget accounting systems raged over the following years until the May 2008 budget was presented to Parliament. It was based solely on the enhanced GFS system, and the ASS budgets were discarded. Several Government enquiries were held into the use of two systems and the relevance of the AAS system for government use (*JCPAA 2002, FRC 2002, HOTARAC 2003-2008, Simpkins Report 2006, SGF&PA 2007, Murray Report 2008*)<sup>3</sup>. As well, some academic articles were published criticising the use of two systems and, in particular, the AAS system (Barton 1999, 2002, 2005, 2007, Challen and Jeffrey 2003, 2004,

<sup>3</sup> Mr. Simpkins was a former Deputy Auditor General of New Zealand, and Senator Murray was a member of a small independent party in the Senate.

2005)<sup>4</sup>. For example, in December 2002 the Financial Reporting Council (FRC), a Government body responsible for determining the broad strategic direction for the setting of standards by the AASB, issued a direction to the Board that it: “...should pursue as an urgent priority the harmonization of Government Finance Statistics (GFS) and Generally Accepted Accounting Principles (GAAP) reporting. The objective should be to achieve an Australian accounting standard for a single set of Government reports which are auditable, comparable between jurisdictions, and in which the outcome statements are directly comparable with the relevant budget statements.” (*FRC Bulletin 2002/5*, 18 December 2002)

Application of AAS to the public sector was based on the ‘sector-neutrality’ principle of the AASB. AAS were originally developed for the published general purpose financial reports of business corporations, and the AASB believed that they could readily be extended to cover all types of entities across the nation. They believed that the AAS Conceptual Framework was appropriate for all accounting systems and that only modest variations in some application details to suit different types of industries were required. Thus, Mr W. McGregor, Director of the Australian Accounting Research Foundation (AARF) stated that:

“An important feature of the concepts statements (i.e., SACS 1-4 at the time) adopted by the Board is that they are applicable to financial reporting by all types of reporting entity. That is, no distinction is made between entities on the basis of...sector location (public or private).” (*Australian Accounting Review*, December 1999, p3)

The AASB eventually responded to the FRC “urgent priority” with the issue of *AASB1049, Whole of Government and General Government Sector Financial Reporting* in October 2007. While AASB1049 incorporated some important improvements to the former standards, AAS29 and AAS31, it remained based on the

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<sup>4</sup> Mr. Challen was Secretary of the Tasmanian Government Treasury & Chairman of the Heads of Treasury Accounting and Reporting Committee (HOTARAC), while Mr. Jeffery was the Tasmanian Government Chief Financial Officer.

AAS *Conceptual Framework* (SAC1, SAC2 and the Framework) and did not respond to many of the core information requirements needed for fiscal policy management. The major changes included in AASB1049 included recognition of the General Government Sector as an accounting entity for the first time, presentation of the financial statements in the GFS format, and use of GFS figures where options were allowed for in the AAS Standards.

The FRC commissioned Mr K Simpkins, to examine the case for the AASB applying sector-neutral standards to the public sector. In his review (2006), he concluded that the Board had not provided a sufficient justification for the principle (p88, para 7.28) nor met the needs of users of public sector entities to the extent that they ought (p102, para 8.25) (*Review*, 2006). However, he noted that the vast majority of provisions relating to transactions recording in AAS apply appropriately to all entities (p112, para 8.66).

It should be noted that the sector-neutral principle primarily concerns the standards underlying the financial performance and position reports, i.e., the conceptual framework illustrated in Figure 2 on p11. These are the main concern of the conceptual framework, whereas accounting standards which underlie the recording of transactions comprising the vast majority of accounting standards can readily be applied across all sectors of users. The sector-neutral concept should be applied to this phase only, i.e., be a sector-neutral transactions principle. It should not be applied to the conceptual framework for fundamentally different types of entity, where the objectives, functions and operating environments differ.

The Senate Committee on Finance and Public Administration (SCFPA), in its enquiry into the *Transparency and Accountability of Commonwealth Public Funding and Expenditure Report* (March 2007) strongly recommended the use of only one system but refrained from stating which one, though its analysis throughout the Report strongly favoured the GFS system.

Next, the Minister of Finance and Deregulation in the new Government (Mr L Tanner) in March 2008 requested Senator A Murray (now retired) to examine and respond to a series of issues listed in his *Operation Sunlight* paper designed to improve transparency and accountability in budget reporting. In his response, Senator Murray recommended that agency and program level expenditures should all use the same standard to enable alignment of their budgets with the General Government Sector *Budget Report* (June 2008). The Government adopted most of the Report's recommendations in December 2008.

Finally, the 2008-09 budget presented to Parliament in May was based solely on the enhanced GFS system which included some of the AASB1049 requirements, but not the important conceptual framework ones. Details of the new system and the differences between AAS and GFS treatments are explained in BP1, 2008-09 in Appendix A, and in later Budget Papers. The budget reported both cash and accrual results. It was also proposed that future outcome financial statements should be presented in a similar format to the main budget statements to enable their comparison.

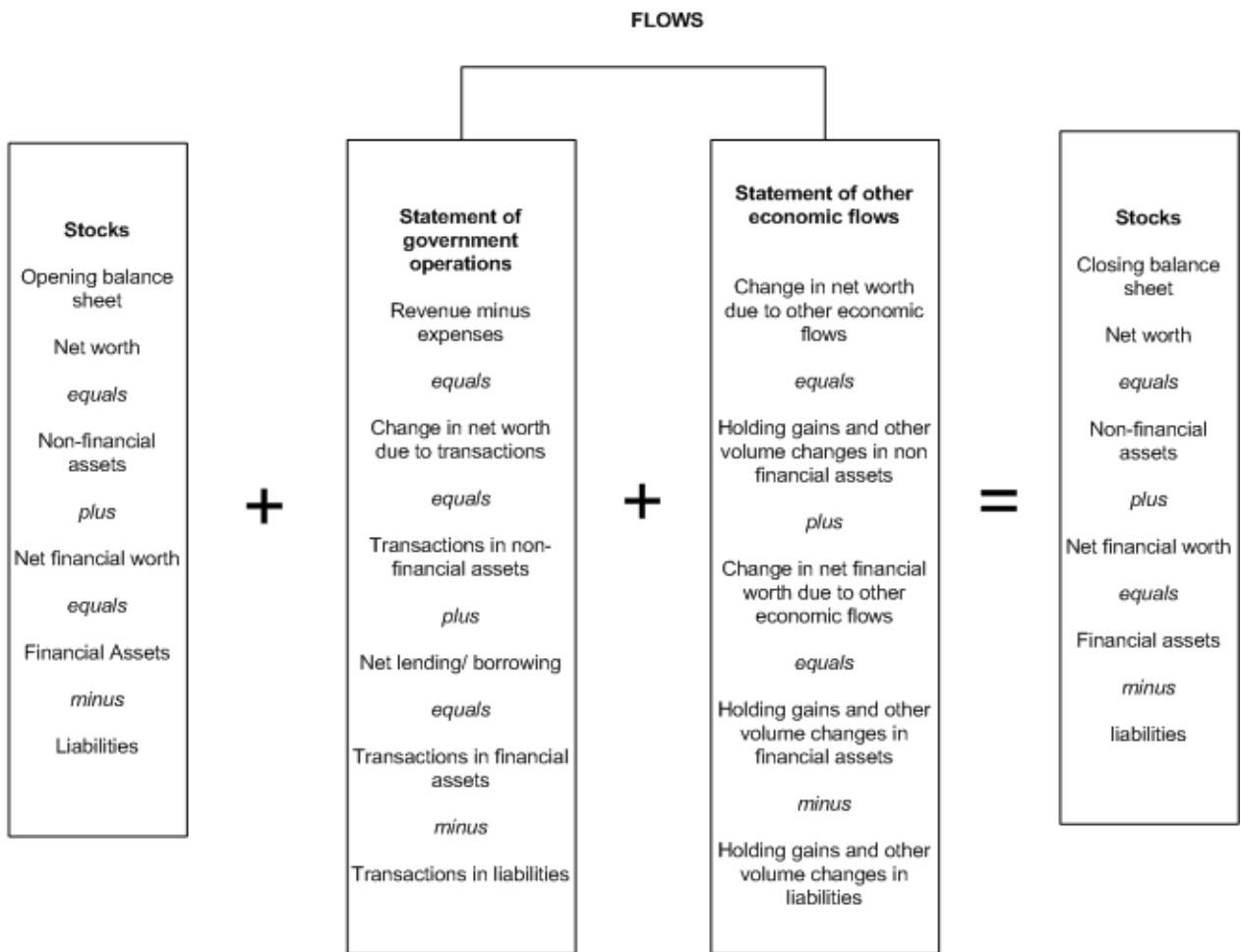
Thus the resolution to the problem of use of two sets of accounting standards was a long and arduous one. The adoption of the enhanced GFS system to incorporate some of the AASB1049 standards relating to the treatment of particular items, but not for fundamental conceptual matters, has greatly simplified and improved budget presentation to Parliament. Further work is still required though with respect to aligning agency budgets and their programs to the aggregate GGS budget, and enhancing all transactions processing from departments into one central data-based transactions system for both cash transactions and accrual transactions. This will enable fulfilment of further *Operation Sunlight Report* recommendations and daily cash management and borrowing requirements.

## **b) Outline of the GFS System**

The GFS system has a simple analytical framework based on Figure 1 and 2 above (pp.11-12) and illustrated in Figures 3 and 4 below (pp 20-21). Its key features comprise:

*i) Distinction between resource flows and resource stocks* because each has differing economic effects. *Resource flows* arise from transactions and directly affect production, sales and employment and enter into the GDP. As well, they affect the stocks of resources at each point in time, i.e., assets. Transaction resource flows involve both the government and external parties and are recognised in accrual accounting as they occur. They are classified into exchange transactions which involve the purchase and sale of items, and transfer transactions which cover service provision to members of the public (pensions, etc.) and taxation revenue. While internal asset consumption (e.g., depreciation and inventory usage) is not a transaction, it is also included as if it were a transaction as it reduces the stock of resources. The transaction resource flows are summarised in the Operating Statement, and they all impact on the balance sheet (see Figures 1 and 3).

## STRUCTURE OF THE GFS ANALYTICAL FRAMEWORK



Source: Government Finance Statistics Manual, 2001, Figure 401, pg. 37

Figure 3

*Other economic flows* record changes to the resource stocks from non-transaction events such as changes in market prices, discovery of new minerals, floods and bushfires. These do not enter into the GDP but do affect the nation's assets.

Changes in asset prices cause holding gains and losses on assets and some liabilities and are recognised for balance sheet purposes. The GFS system uses current market values for measuring its assets and liabilities. Abnormal items such as new mineral discoveries and natural disaster losses are normally irregular and unpredictable. They are non-transaction events which affect the balance sheet, and are shown in a separate

section of the operating statement in the revised Australian GFS system, but in a separate statement in the IMF system.

## STATEMENT OF GOVERNMENT OPERATIONS

### Transactions affecting net worth

#### Revenue

- Taxes
- Social contributions
- Grants
- Other revenues

#### Expense

- Compensation of employees
- Use of goods and services
- Consumption of fixed capital
- Interest
- Subsidies
- Grants
- Social benefits
- Other expenses

NET/GROSS OPERATING BALANCE STATEMENT

### Transactions in non-financial assets

#### NET ACQUISITION OF NON-FINANCIAL ASSETS STATEMENT

- Fixed assets
- Change in inventories
- Valuables
- Nonproduced assets

NET LENDING/BORROWING STATEMENT

### Transactions in financial assets and liabilities (financing)

#### NET ACQUISITION OF FINANCIAL ASSETS

- Domestic
- Foreign

#### NET INCURRENCE OF LIABILITIES

- Domestic
- Foreign

1. The net operating balance equals revenue minus expense. The gross operating balance equals revenue minus expense other than consumption of fixed capital.
2. Acquisitions minus disposals and consumption of fixed capital.
3. Net/Lending/borrowing equals the net operating balance minus the net acquisition of non-financial assets. It is also equal to the net acquisition of financial assets minus the net incurrence of liabilities

*Source: Government Finance Statistics Manual 2001, Table 4.1 p. 38.*

Figure 4

ii) *Use of a transactions-based recording and financial reporting system.* As in Figure 1, all cash transactions are recorded and reported directly into a cash flow statement, and likewise all transactions (cash and credit) are recorded and reported directly into the operating statement. The *transactions-based recording* system is not a new one – it was developed by the inventor of double entry bookkeeping, Luca Pacioli in 1494! I also used it in my text, *The Anatomy of Accounting* (1974). In a central data-based FMIRS, all the information is on-line, and the transaction reports can be reported promptly for management purposes. This is necessary for efficient cash management by the entity. Internal asset consumption charges and other economic flow events can then be recorded periodically for preparation of the enlarged Australian operating statement and balance sheet.

iii) *Presentation of three financial statements in the Australian version* (or four in the IMF version). The *Operating Statement* summaries total transaction revenues and expenses (including asset consumption charges) to derive the net operating balance from the period's activities, followed by the other economic flows to determine the total change in net worth of the government over the period. An extra note adjusts the net operating balance by the net acquisition of non-financial assets to determine the fiscal balance which shows the extent of the government's net lending/borrowing for the period, and is the accrual counterpart to the headline cash balance. The *Balance Sheet* summarises all the assets and liabilities of the government and its resultant net worth. The *Cash Flow Statement* summarises separately the cash flows from operating transactions to derive the cash operating balance (the underlying deficit/surplus); the cash flows from capital transactions (purchase and sale of non-financial assets) to derive the government's new investment in capital formation and the headline deficit/surplus which quantifies its calls on the capital market; and its cash flows in financing activities (purchase and sale of financial assets, borrowings and repayment of liabilities).

Public sector accountants have shown little interest in the GFS accounting system to date because they apparently believe it is just a statistical measurement system. But all accounting systems can be categorised as financial information statistical measurement systems. The GFS system is a comprehensive cash and accrual financial management information and reporting system (FMIRS), as business accounting systems are intended to be. The GFS system is designed to provide the financial information required in budgets and outcome statements for fiscal policy and resource management purposes as outlined on pp6-9 above. It is based on double entry recording of all external transactions for the preparation of cash flow and accrual operating statements, and incorporates relevant financial events for the measurement of comprehensive revenues, costs and budget balances, and for all assets, liabilities and net worth of governments. These are the same broad procedures

used in business accounting. The differences between the GFS and AAS systems occur in the conceptual framework specifications for each sector in order to make each information system relevant for the nature, purpose and operating environments for each type of entity.

### **c) Comparison of the GFS and AAS Financial Performance and Position Statements**

While the recording of transactions is much the same in both systems, major differences between the two systems occur in the statements of financial performance and position (see Figures 1 and 2). The differences arise from the information objectives of each system, the concepts used, the basis of asset and liability valuation and their forms of presentation. The main differences are enumerated below:

- *Use of a transaction and other economic flows approach* versus a balance sheet approach. The AAS analyses where and how to record transactions and events in terms of their effects on the balance sheet and derives the rules for debit and credit entities there from.

The GFS uses a transactions flow approach – all resources received flow into a debit entry account (e.g. for expenditures and cash receipts) while the source of the flow is credited to its account (e.g. from the bank account and taxpayers). This simple approach requires only two rules for determining debits and credits in double entry systems – debit inflow accounts and credit outflow accounts as the source of the item.

- *Objectives.* AAS statements appropriately focus on the measurement of profit and financial position of a business, and the Standards are restricted to the published financial statements. Their aim is to present information useful for external users, and particularly investors, for making and evaluating decisions about the allocation of scarce resources. Later, some responsibility for management accountability was added when the Standards were extended to include the public sector (SAC 2, paras 43 and 44).

GFS statements focus on assisting governments to formulate and implement fiscal policies, management of resources, and their accountability to parliament and the public (*GFS Manual*, 2001). Internal management are the major users for the first two purposes, and parliament is the major accountability customer.

- *Assets*. AAS assets are resources controlled by the entity from which future economic benefits are expected to flow to it. Control rather than ownership is required for their recognition, and they must provide their economic benefits to the business (*Framework*, para 49).

GFS assets are resources owned by the government which are expected to provide future benefits to the government or the community. The benefits need not be income producing for the government as most of them are community services provided to the public (*Manual*, p 112).

- *Equity*. AAS equity, calculated as assets less liabilities, measures the owners' investment in the business and is required to assess its solvency and rate of return on investment (*Framework*, para 49).

GFS net worth is likewise calculated but is not used to assess the government's solvency and rate of return; rather it is a measure of the extent to which government owned assets (where they can be measured) cover its liabilities.

- *Balance sheets*. AAS balance sheets report all assets and liabilities to enable investors and other users to assess the entity's financial position, including its liquidity and solvency of the business and the rate of return on investment.

GFS balance sheets also report government assets and liabilities, though only those which can be reliably valued. The inability to obtain reliable valuations applies particularly to many cultural and environmental items, and top secret defence equipment, as active markets may not exist for them. While it shows the government's liquidity, it is not a complete measure of its solvency and other attributes of financial position. Governments do not have contributed capital to

provide the funds for investment in its assets; rather they have a more valuable source of funding – the power to tax but it is not shown as an asset. Hence a negative net worth (as currently exists) does not imply bankruptcy as it would for a business.

- *Valuation bases for assets and liabilities.* AAS allows use of the complete range of valuations from historical cost, through current values and fair values, to present values (*Framework*, paras 100-101). Where different bases of valuations are used, the aggregates can lack meaning and the measures of liquidity, solvency and rates of return can be unreliable. Also, the use of different valuation bases affects the measures of income, asset consumption charges and profit in the financial performance statement, and hence their reliability.

GFS requires the use of current values throughout where available – current realizable values for financial assets and liabilities and for physical assets awaiting disposal; and current replacement costs for non financial assets which are to be retained for future use (*Manual*, p.114).

- *Capital maintenance.* AAS is based on the concept of financial capital maintenance which is used as the basis for measuring net profit (*Framework*, para 102). However, where several valuation bases are mixed together (as is often the case), the capital maintenance base can be somewhat flexible. This affects the asset consumption charges and hence net profit, and the measurement of assets, financial position and rate of return on investment.

GFS uses the basis of maintaining intact the physical operating capability of its assets so that governments can continue to provide the current level of services into the future (where the net operating balance does not become negative) (*Manual*, p 114).

- *Income.* The AAS concept is confusing. Normally in business income and profit are synonymous. But in AAS income refers to gross income which comprises revenue from operating sales and profit on disposal of assets, and it can also include unrealized holding gains and losses on assets. (*Framework*, para 74).

GFS confines revenue to operating transactions that increase net worth, principally taxation collections. Proceeds from the sale of physical assets (other than inventories held for sale) and holding gains and losses are excluded. They are reported in Other Economic Flows.

- *Expenses.* AAS expenses are decreases in economic benefits that reduce equity. They include normal operating costs, losses on asset sales or liability repayments, and unrealized losses on assets. (*Framework*, paras 78-80). The definition does not mention that expenses are incurred to produce outputs for sale to customers and hence benefit the business.

GFS expenses are confined to transactions in service provision that reduce net worth together with asset consumption charges.

Hence these basic differences in the objectives, operating environments and functions of each sector result in some very different concepts and bases for their measurement. The GFS concept definitions are more rigorous and relevant than their AAS counterparts. The financial statements of each sector cannot readily be compared, and use of the sector-neutral approach to accounting standard setting to apply business accounting standards for the measurement of financial performance and position to the public sector is unsound. Furthermore, even when both the GFS and AAS budgets for the same entity, i.e., the GGS, were reported to Parliament, nearly all the figures were substantially different (Barton 2007, Tables 1 and 2, pp. 13 and 14).

A summary of the Government's policy on adoption of the enhanced GFS system is given in Appendix A of its annual Budget Paper No. 1. The policy restricts the Government to use the preferred treatment of items drawn from only the AAS or GFS standards. It also lists the differences between the two systems for each of the items where they occur.

#### **d) Evaluation of the GFS System**

The GFS system is a superior FMIRS system to both alternative systems of cash accounting and budgeting alone, and to the AAS accrual accounting system. The system was designed specifically for government use and it takes into account all the special features of governments which distinguish them from the private sector, and hence the information provided is relevant to the needs of government and parliament. It is a comprehensive FMIRS which provides governments both with the financial information they require to undertake their desired fiscal policies and to manage their resources efficiently. A complete cash accounting and budgeting system can be an integral part of it to provide the information required for fiscal policy and cash management purposes, along with the full accrual information required to manage all the governments resources efficiently and to assist in longer term fiscal policy sustainability management and intergenerational equity considerations.

i) *Cash accounting and budgeting systems (CABS)*. Cash budgets and outcome reports are required for annual fiscal policy purposes and for assessing the liquidity of the GGS. The cash budget shows the government's intended expenditures on each area of service provision to the public and its own administration costs, and the extent to which taxes and other revenues fund them and the resultant budget surplus or deficit. These cash flows also impact on financial markets and interest rates. As well, the statements show the details of the reallocation of resources from the private to the public sectors. This information is required to improve upon the distribution of resources occurring in the private sector in order to enhance community economic and social welfare.

CABS is also necessary for efficient cash management by the government to ensure it has the liquidity to fund its daily operations and to minimise the borrowings required to fund cash deficits when they occur.

Finally, CABS information is required at the departmental level for budget legal compliance and accountability purposes in addition to managing operations.

Departments must operate within their budgets.

*ii) Accrual accounting and budgeting systems (AABS) summarised in the operating statements.* Accrual budgets and outcome financial statements are required primarily for the good management of total government resources. These are largely departmental management responsibilities. Information on total revenues and costs of service provision, and on all assets and liabilities, must be known to enable their good management and thereby enhance efficiency of operations (a major criticism of earlier reviews of government operations) and departmental accountability to parliament for their performance.

The operating statements show the net operating balance (i.e. total revenues less total costs of service provision) which is the accrual counterpart to the cash operating balance. A zero balance indicates there is no effect of current service provision on the government's net worth and ability to maintain the provision of services into the future, and hence no adverse intergenerational effects. The valuation of non-financial assets at current replacement cost and charging depreciation thereon means that the measure of the net operating balance is based on the concept of physical capital maintenance. A deficit results in a reduction in operating capability and in net worth. It indicates that, under present conditions, the fiscal policy is unsustainable into the long term and will require borrowing to support it. This has adverse intergenerational effects. Conversely, an accrual budget surplus increases government net worth so that it can fund additional capital investment on facilities or pay down government debt. Future generations benefit from such a result. The fiscal balance (obtained by adding net purchases of non-financial assets to the net operating balance) measures the government's investment/savings balance. Hence both measures of budget balance have important macro-economic consequences.

*iii) The GFS balance sheet* is a useful statement which summarises the stocks of measurable government financial and non-financial assets and its liabilities at balance

date, and hence its net worth. Information on these assets and liabilities is required for their good management. However the balance sheet is not a full statement of financial position, as a business balance sheet is meant to be, because it does not include the taxation powers of government and non-measurable resources as assets. Taxation powers replace the government's need to raise equity capital from investors, while detailed physical and maintenance records are normally kept for assets having no reliable financial valuations.

## **CONCLUSION AND SOME UNFINISHED BUSINESS**

The enhanced GFS cash and accounting system is superior to the alternative systems. It reports the information they require for their provision of services to the nation in an efficient and effective way; manage the economy and its natural and cultural environments; and the longer term sustainability of present fiscal policies and their intergenerational equity effects. In addition it provides the information required for good management of the government's resources. It has an analytically simple and rigorous conceptual framework which provides the basis for a comprehensive, quality FMIRS.

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