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Mr David Monk
Manager
Public Accounts Committee
Parliament House
Macquarie Street
Sydney NSW 2000

Dear Mr Monk

Review of Reporting Requirements for Small Agencies - Discussion Paper

CPA Australia welcomes the opportunity to provide input into the Public Accounts Committee's *Discussion Paper – Review of Reporting Requirements for Small Agencies.* Financial reporting in the public sector is an extremely important part of public sector governance and accountability.

Given the current debate over reporting based on government finance statistics (GFS) and generally accepted accounting principles (GAAP) reporting, the move to international financial reporting standards and examination of corporate governance in the public sector by the Victorian Public Accounts and Estimates Committee, it is timely for the NSW Public Accounts Committee to be examining issues of public sector reporting and its overall impact on governance and accountability in NSW.

In developing these comments we have consulted with areas of expertise within CPA Australia - our Public Sector Centre of Excellence, the External Reporting Centre of Excellence, the Audit and Assurance Centre of Excellence and the NSW Public Sector Committee. Through this consultative approach, we have been able to canvass the views of our members working within the public sector (across the three tiers of government), as well as specialists in external reporting.

We hope that the attached submission is useful in the Public Accounts Committee's deliberations on a very important issue for the public sector. Should you require any further information regarding this submission please contact Mr Adam Awty, Director, Public Sector, on (03) 9606 9858 or adam.awty@cpaaustralia.com.au.

Yours sincerely

Mark Hoddinott FCPA

President, NSW Divisional Council

Enc.

cc: G. Larsen
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CPA AUSTRALIA

Submission to the NSW Public Accounts Committee

Review of Reporting Requirements for Small Agencies – Discussion Paper

4 March 2003

TABLE OF CONTENTS

LIST OF ACRONYMS AND ABBREVIATIONS

AASB	Australian Accounting Standards Board
GPFR	General purpose financial reports
PAC	Public Accounts Committee
SAC	Statement of Accounting Concepts

EXECUTIVE SUMMARY

CPA Australia is one of the world's largest accounting bodies, representing 98,000 finance, accounting and business professionals in Australia, Asia and Europe with over 10,500 of these professionals working in the public sector. With such a large public sector membership CPA Australia is keenly aware of the importance of sound financial reporting for public sector accountability and transparency. This submission has been prepared with due regard to the current reporting requirements in Australia. It is also the view of CPA Australia that financial reporting and disclosure is a key element of public sector accountability.

CPA Australia does not support differential reporting for small agencies within the current framework for financial reporting for public sector agencies. CPA Australia also believes the need for public accountability and transparency in this instance may outweigh the perceived cost burden of preparing General Purpose Financial Reports and subsequently having them audited.

CPA Australia does however, recognise that the compliance burden is a real issue for small agencies but believes the issue needs to be addressed nationally through the Australian Accounting Standards Board (AASB).

CPA Australia believes that fundamental to any public sector reporting framework is the needs of users, whilst maintaining public sector accountability expectations.

1.0 BACKGROUND

1. CPA Australia is one of the world's largest accounting bodies, representing 98,000 finance, accounting and business professionals in Australia, Asia and Europe with over 10,500 of these professionals working in the public sector. With such a large public sector membership, CPA Australia is keenly aware of the importance of sound financial reporting for public sector accountability and transparency.

2. We have provided responses to the questions posed by the NSW Public Accounts Committee (PAC) in its Discussion Paper to with the aim of assisting the Committee in its examination of the reporting requirements for small agencies.

2.0 CONSULTATION

3. In developing these comments we have consulted with our Public Sector Centre of Excellence, the External Reporting Centre of Excellence, the Audit and Assurance Centre of Excellence and the NSW Public Sector Committee. Through this consultative approach, CPA Australia has been able to canvass the views of our members working within the public sector (across the three tiers of government), as well as specialists in external reporting.

3.0 GENERAL DISCUSSION

Background

4. In preparing our response to the PAC's Discussion Paper, CPA Australia has attempted to provide information on each question and also look at the underlying principle or issues which need to be considered when considering the reporting requirements for small public sector entities.

Reporting Entity Concept

5. Currently, accounting standards in Australia require bodies who are, or who are deemed to be reporting entities to prepare general purpose financial reports (GPFRs). This applies to all sectors, including the public sector. Therefore, one of the first considerations to be addressed in contemplating the reporting requirements for small public sector agencies is whether they are in fact a reporting entity and therefore need to prepare GPFRs.

6. Under the current reporting entity concept it is necessary to establish the dependence of users of an entity's GPFRs in order for it to be a reporting entity. Furthermore, under Statement of Accounting Concept (SAC) 2 and Australian Accounting Standard, AASB 1025: Application of the Reporting Entity Concept and Other Amendments, an entity is a reporting entity if there exists users who are dependent on information to make decisions about the allocation of scarce resources.

General purpose financial reports

7. One of the fundamental questions posed by the PAC is whether small entities should be required to prepare GPFRs and subsequently have them audited. Before answering this answer it is necessary to consider:

   - the definition of a small agency; and
   - the purpose of GPFRs.

8. There appears to be a large range of agencies captured within the definition of 'small agencies' which are defined by the number of employees, employed by the agency. This tends to group reporting entities together by full time equivalent staffing with vastly different roles within government, asset bases, funding bases (ie Budget Sector agencies vs Statutory Authorities), and therefore small is not linked to financial or risk indicators within an agency.

9. The purpose of GPFRs is that an entity, "... shall provide information useful to users for making and evaluating decision about the allocation of scarce resources" (SAC 2, paragraph 43). Also, "Management and governing bodies shall present GPFRs in a manner which assists in discharging their accountability (SAC 2, paragraph 44)".

10. One of the fundamental reasons for GPFRs is to provide information to facilitate informed decisions by '... users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all their information needs' (SAC 2, paragraph 5).

5.0 RESPONSE TO PAC QUESTIONS

Who are the users of financial and annual reports?

11. The users of public sector GPFRs are many, however, it is important that in considering the question of users of financial and annual reports reference be made to the definition within SAC 2 – Objective of General Purpose Financial Reporting. SAC 2 describes various categories of users and their information needs. In particular, it highlights three primary users of general purpose financial reports all of which are applicable to public sector entities big and small.

12. SAC 2 provides the following definitions for each primary category of users:

    a. Resource providers (paragraph 17) – *Providers of resources include those who may be compensated either directly or indirectly for the resources they provide. The former category includes employees, lenders, creditors, suppliers and in the case of business entities, investors and contributors. The latter category includes donors, member of non-business entities such as clubs, societies and professional bodies, and, in the case of the public sector bodies such as Parliament, taxpayers and ratepayers* *b.* Recipients of goods and services (paragraph 18) – *Recipients of goods and services are those who consume or otherwise benefit from the goods and services provided by the reporting entity. This category comprises customers and beneficiaries. In many non-business entities recipients of goods and services include resource providers, for example, ratepayers, taxpayers and members of professional associations.*

c. Parties performing a review or oversight function – *Certain parties, including Parliaments, governments, regulatory agencies, analysts, labour unions, employer groups, media and special interest community groups, perform an oversight or review services on behalf of the community. Members of this group tend to have indirect or derived interests in general purpose financial reports since they advise or represent those who have direct interest.*

13. SAC 2, paragraph 20, also recognises that '... management and governing bodies are another category of user interested in the information provided in general purpose financial reports. However, managements and governing bodies need, in addition to the information contained in general purpose financial reports, management accounting and other information to carry out their planning and control responsibilities'.

14. The public as a whole translates to many users of the GPFRs produced by small agencies. As taxpayers and rate payers, members of the public are both resource providers and recipients of goods and services. As such they are unable to control the preparation of reports and hence unable to have them tailored to satisfy their particular information needs. This is one of the fundamental reasons why small agencies are required to prepare GPFRs.

Do the Parliament and the public need to know the detailed financial circumstances of very small entities?

15. The purpose of producing financial reports is to help users make informed decisions as to the allocation of scarce resources. In the public sector financial reports are a critical element of the overall governance and accountability framework as the resources applied in the delivery of goods and services are public monies.

16. Whilst the Parliament and the public may not always be interested in the financial circumstances of individual entities and it could be argued from a materiality and risk management view that it is not imperative - the Parliament ultimately is accountable to ensure public moneys are applied efficiently and effectively. On a materiality basis, it may well be argued that Parliament and the public do not need to know the detailed information of very small agencies. However, the final answer must consider what other scrutiny of their activities exists. In particular, the annual audit may be the most effective way overall of providing assurance and making management accountable for the activities of small agencies.

17. Even though in most cases the Parliament is the primary user of financial statements, other users who cannot independently request reports about how resources have been allocated would be disadvantaged if GPFRs were not produced. So despite the size of an entity, its activities are still of critical importance to its "secondary users" and the agency should be held accountable.

Does the need for accountability for public money and assets outweigh any possible efficiency gains by reducing the number of agencies required to prepare reports and be audited?

18. CPA Australia believes that the need for accountability in relation to public resources does outweigh efficiency gains achieved through reducing the number of agencies required to prepare financial reports and have them audited. This notion of public accountability is further supported by the establishment of independent agencies. Examples in NSW include the Independent Commission Against Corruption and the NSW Ombudsman.

19. Inherent in governance and accountability frameworks is a question that the Parliament needs to consider: How much is it willing to pay for an effective accountability framework?

20. The question of accountability versus efficiency also needs to be considered in terms of what benefits beyond accountability may be lost if agencies are not required to have the discipline of preparing GPFRs and then to have them audited. Benefits include:

    a. for many small agencies, the audit contact through the annual financial statement may be the only external auditing work done in that agency over a period of years.

    b. there may be unmeasurable but significant benefits in terms of systems controls and behaviour as a result of being subject to an independent annual financial audit.

    c. the production of audited annual reports by small agencies may satisfy potential users who in the absence of such reports may need to request additional information at a cost to the user and or, agency.

    d. reducing risk in terms of political damage, loss of reputation, negative public perception and lack of credibility.

21. While accounting should not drive business it could also be appropriate to review whether you could attain efficiency gains through subsuming the activities of smaller agencies into larger authorities and as such increase current accountability levels through better corporate governance and enhanced internal controls etc. The rationale is that activities within larger entities that are small or very small will be subject to the control environment and the controls that operate within a large organisation, whereas, where the activities are stand-alone, this aspect is not available.

22. If the cost of accountability is believed to be excessive, other options to maintain an appropriate level of accountability within the current framework may need to be explored, such as:

    a. to avoid the annual cost burden of an audit, relevant State legislation could be amended to require GPFRs of small agencies to be audited on a random or triennial basis, with the GPFRs provided to Treasury or the PAC annually.

    b. to implement shared service arrangements whereby the financial reporting function (and even day to day accounting) of small agencies are centralised to obtain benefits from economies of scale.

23. However, there may be associated risk trade-offs in doing this and therefore the alone are not fully supported by CPA Australia.

Would there be any benefit in reducing the level of scrutiny for small agencies? If so, what criteria would be appropriate?

24. The Discussion Paper focuses on audit scrutiny of the financial statements of small agencies. Without identifying what other means of scrutiny exist (eg the annual budget process, internal audit, etc), it is difficult to answer this question definitively.

25. However, it is reasonable to assert a principle that the degree of scrutiny (and hence its cost) should be commensurate with the size, significance and risk profile of the agency involved. The current grouping of small agencies within NSW may not consider the combination of these factors and may just focus on the number of employees employed by that agency.

26. The most obvious benefit in reducing the level of scrutiny for small agencies would be the perceived saving in cost and time. These savings in turn could be reallocated to the NSW Audit Office to undertake more performance audits to improve sector performance for example. However, the downside of reducing the level of scrutiny could see increased risk in the event of systemic failure arising out of agencies' activities, as a result of the reduction of checks and balances.

27. As all agencies are financed with public money, the public are entitled to know how their money has been used and if it has been used in an efficient and effective manner. While on this basis the preparation of GPFRs is justified, it may be possible to decrease the audit burden by performing audits on a triennial basis. However, to do so will require more scrutiny from management so that accountability is not reduced.

28. The Parliament will need to consider the risks associated with each agency by undertaking periodic independent risk assessments of the extent and likelihood to which an entity may be exposed to material misstatements, that is significant errors in reporting.

Is it essential to maintain a link between financial reporting requirements and the need to prepare an annual report?

29. In most cases the answer is yes. This is particularly so in the public sector where readers of GPFRs are looking for a complete picture of how an entity has performed. GPFRs only provide part of the overall picture of that performance. While there are often only financial statements in the public sector, if readers do not have qualitative explanations of performance, they are less able to make a judgement as to how well resources have been applied to achieve an entity's objectives. Clearly in the case of a small agency the level of detail in an annual report will be a judgement made by management, in relation to user expectation and need.

Would the State's financial reporting be subjected to any additional risks by creating differential levels of reporting?

30. In the context of small agencies, the answer could potentially be no, however such a move would be a trade-off between risk and cost efficiency. In such an event three matters would need to be considered. There are:

    a. Not requiring small entities to produce audited statements may lead to a significant increase in the number of such entities.

    b. A stringent framework to decide which entities need to report is required, for example criteria such as size of assets, revenue base and risk profile, such as the ability of an entity to enter into commitments.

    c. Creating differential levels of reporting could create additional risks. The criteria used to link the small agency to its appropriate level of reporting could obviously produce risks such as agencies being wrongly classified to lower reporting requirements if the criteria subjective.

31. Currently there is no provision under the current accounting standards to allow for the preparation of differential GPFRs. However, differential reporting is possible by non-reporting entities that can produce special purpose financial reports, but as small agencies are reporting entities, special purpose reports as the sole reporting mechanism is not an option.

32. The question of differential reporting was considered in 1989 by the Australian Accounting Research Foundation, in Discussion Paper 13 – Differential Reporting: Nature of the Accounting Standards Overload Problem and a Proposal for its resolution.

33. It was recognised in this paper that differential reporting by small companies was an inappropriate solution to the accounting standards overload problem. In particular "... it is not readily apparent whether the term small should be interpreted as reflecting size characteristics only, or whether it should also encompass ownership characteristics" (p. 22). The Paper argued that any "... solution for the alleged accounting standards overload problem, [should]

be based on a concept broader than the definition of 'small company'. Ideally, it should be based on the fundamental argument underlying the call for differentiation, that is, that there are few, if any users of the financial reports by the entities" (p. 23). Hence, the reporting entity concept.

34. Since that time the *First Corporate Law Simplification Act 1995* (Cwlth) has come into effect for small proprietary companies, which is consistent with the notion of limited users. In this case the users are usually acutely aware of the operations of the company and can readily seek the information they need without GPFRs. The overriding concern with public sector entities is that users (ie the public) are not able to demand information from the agency on an as needs basis and therefore require preparation of a GPFR even though they may be "small". SAC 1, paragraph 36 states that "... the existence of users dependant on general purpose financial reports is not determined by either the size or the ownership characteristics of an entity".

Who should review classifications under a system of differential levels of reporting? How often? Should these reviews be subject to parliamentary scrutiny?

35. Whilst CPA Australia does not support differential reporting in this context within the current framework, if differential reporting were to be implemented, it would recommend that the criteria would be reviewed by either the Parliament or the PAC on a rotational basis. Furthermore, such reviewing should occur at a national level on the basis of cross-jurisdictional uniformity and comparability. These concepts would be compromised if each government were to introduce their own differential reporting regime.

36. If differential reporting were to be introduced, we recommend that at a minimum, differential financial reporting would require measurement and recognition criteria within accounting standards to be applied in the preparation of financial statements, with only disclosure requirements being reduced.

What level of resources are required to prepare annual and financial reports? Is this onerous for small agencies?

37. The level of resources varies from agency to agency. It may be onerous for small agencies who have little skills in financial reporting and do not have resources to meet the reporting requirements.

Would it be appropriate to enable smaller, low risk agencies to prepare less comprehensive financial reports?

38. Whilst CPA Australia does not support differential reporting in this context within the current framework, if differential reporting were to be implemented, accounting standards would need to be changed to allow comprehensive financial reporting as currently there is no accounting standard which allows 'less comprehensive' reports in any sense other than by applying materiality considerations. Concise Financial Reports under Australian Accounting Standard, AASB 1039: *Concise Financial Reports*, apply only to entities listed in the *Corporations Act 2001* (Cwlth) and are in addition to full financial statements. That is, they serve not to lessen the cost of scrutiny but simply to limit the information for readers.

If so, what criteria would provide the right balance between risk and accountability?

39. There is no 'right' balance between risk and accountability. CPA Australia considers this to be a matter of judgement to be exercised by the Parliament.

What should be included in a concise financial report?

40. Australian Accounting Standard, AASB 1039: *Concise Financial Reports*, should serve as a model, however, consideration would need to be given to the public sector specific issues such as the reporting of administered items. As previously discussed, concise financial reports are in addition to full financial statements, they are not stand alone.

How often should decisions be made about an agency's reporting requirements?

41. Whilst CPA Australia does not support differential reporting for small agencies within the current framework, if an agency's reporting requirements were subject to differential reporting, the agency should review its status every year with regard to the appropriate level of reporting.

42. Also this should be subject to independent review by the Parliament.

What are the risks if the level of audit for small entities is reduced?

43. There is often no internal audit processes to check internal controls in small agencies and the external audit may be the only time that there is an independent check on controls.

44. In a worst case scenario it could result in the failure of an agency because there has been no check as to whether it is a going concern and financially viable.

45. There are also risk issues with political, reputation, public perception and credibility outcomes.

46. For many small agencies, the audit contact through the annual financial report may be the only external auditing work done in that agency over a period of years. An independent audit will create management accountability for the financial report.

47. There may be unmeasurable but significant benefits in terms of systems controls and behaviour as a result of being subject to an independent annual financial audit. While an audit is not designed to uncover fraud, by ensuring appropriate controls are in place, instances of fraud and misappropriation may be reduced.

Has the Audit Office added any benefit by performing reviews of very small agencies included in the PFA Regulations by identifying accounting control problems or other financial management issues?

48. At this time CPA Australia is not in a position to comment directly on the NSW Audit Office but it is assumed that audits have provided the basis for judging the controls small agencies require to operate effectively, and the agency takes up the recommendations, the internal control structure is strengthened reducing the risk of significant misstatement.

Who should decide whether organisations are subject to this level of scrutiny? The Government? The Treasury? The Parliament?

49. If reducing the level of scrutiny is an option, the Parliament and the PAC (on delegation from the Parliament) should make the final decision as to the level of scrutiny an organisation is subjected to. Their decision should be based on information provided by Treasury after a full review of the definition of 'small agency' is undertaken.

What should be the criteria for deciding the reporting requirements for agencies? For instance, should it be the size of the budget, assets or whether their activities are commercially focused?

50. The existence of users of GPFRs should the deciding factor, that is the Reporting Entity Concept with the current Australian accounting framework.

Should there be a regular revision of the organisations included in the invited audits list?

51. CPA Australia is of the view that the invited audits list is not applicable to small agencies. CPA Australia considers all public sector agencies to be reporting entities, which are required to prepare GPFRs.