

For information

Legislative Council Panel on Financial Affairs

**Report on Public Consultation on
Review of Government Financial Reporting Policy**

Purpose

This paper briefs Members on the outcome of the public consultation conducted on the proposed changes in the Government's financial reporting policies, and our proposed way forward.

Background

2. At the meeting on 7 May 2001, we briefed Members on the Government's initiatives and plans to improve its accounting practices based on the recommendations of the Task Force on Review of the Government's Financial Reporting Policy (the Task Force). The Task Force's recommendations were published immediately afterwards for public consultation until 30 June 2001.

Results of the Public Consultation

3. We received twelve submissions¹. The Hon Eric Li and others

¹ These include submissions from the Audit Commission, Fire Services Department, Lands Department, The Hong Kong Housing Authority, The City University of Hong Kong, Citizens Party, The Hong Kong Association of Banks, The Hong Kong Democratic Foundation, The Hong Kong Institute of Directors, The Hong Kong Society of Accountants, Mr. D.C. Oxley (Council member of the Hong Kong Society of Accountants) and Mr. Peter Wong (former Member of Legislative Council).

also commented in the June 2001 issue of the journal published by the Hong Kong Society of Accountants. They all support the Government's proposal for introducing accrual accounting. Respondents generally agree that it will help improve the Government's cost-effectiveness, decision making, stewardship and accountability of resources, and facilitate better understanding of Government's financial performance and position. Some respondents suggest that more should be done, and that the Government should move towards accrual budgeting. The following summarises the main comments together with our responses.

Higher Level Vision and Final Objectives

4. Some respondents comment that the Government has not spelt out the higher level vision of what accrual accounting is believed to be capable of achieving in terms of facilitating public sector reforms. Others suggest that, although the Government may not be able at this stage to fully comply with the International Public Sector Accounting Standards (IPSASs) issued by the International Federation of Accountants, the goal should be for the Government to move towards harmonisation with IPSASs within a definite timeframe. Some respondents find it important to comply with the generally accepted accounting principles (gaaps) especially IPSASs.

Our response

5. Public sector reforms involve much more than a simple change of accounting basis. Considering what and how public sector reforms should be implemented is beyond the scope of this review. As for harmonisation with IPSASs, we accept that it should be the longer term goal for the accrual-based Government Accounts to conform to the requirements of

IPSASs subject to necessary modifications to accommodate local situations.

Accrual Budgeting

6. One respondent suggests that accrual budgeting should be adopted while the Director of Audit recommends that accrual budgeting be considered in the post-implementation review scheduled by the Task Force to be made in 2006-07.

Our response

7. Accrual budgeting requires the pre-existence of accrual accounting and we agree that 2006-07 is an opportune time to consider this subject.

Co-existence of the Accrual-based and the Cash-based Accounts

8. Some respondents are concerned that the different surplus or deficit figures produced by the two sets of accounts would cause confusion. They believe that in the long run there should be a single system unifying cash and accrual accounts. There is also a suggestion that the Government should prepare the accrual-based accounts only.

Our response

9. We believe that, at least initially, it will be necessary to provide both cash-based and accrual-based accounts. The cash-based accounts will demonstrate the Government's stewardship of the sums appropriated each year by the Legislative Council for the delivery of government

services, while the accrual-based accounts will focus on the costs of the services being provided. We have undertaken to ensure that reconciliation statements and explanations will be provided to minimise the difficulties that may be experienced by readers.

Legislative Change and Audit

10. The Director of Audit urges the Government to consider amending the relevant legislation to provide a statutory framework for the preparation and audit of the accrual accounts because this will enhance the credibility of the entire financial reporting system. He also considers it important for the Government to work out, in consultation with the Audit Commission, an early target date for conducting a formal audit on the accrual accounts and, during the initial trial period, an arrangement for “dry-run audit” (i.e. with the result not published) of the accrual accounts.

Our response

11. We shall discuss with the Director of Audit on how to take forward his proposals on the audit of the accounts. As for legislative changes, it is more appropriate to consider this subject after the successful implementation of the accrual accounts. The post-implementation review in 2006-07 will revisit this issue.

Land

12. Some respondents consider it necessary to recognise land as an asset in the Government’s balance sheet because of its importance.

Our response

13. We accept that there are advantages in terms of transparency and accountability for all government land to be reported in the balance sheet. However, it may not be possible to do so for the majority of the land owned by the Government because there is no parallel in the private sector to which reference can be drawn to make the valuation, for example, for land occupied by infrastructure assets (such as roads, streets, airport, landfills, etc.), public facilities (such as parks, playgrounds, swimming pools, public conveniences, etc.) and government facilities (such as police stations, prisons, etc.). As has been made clear in the Task Force Report, apart from the land allocated for investment purposes which has already been reported as investments in the balance sheet of the Capital Investment Fund, only the land occupied by the Government for general uses (such as offices, warehouses, carparks, etc.) lend themselves to an objective valuation. We do not recommend valuation be made for this kind of land *at this stage* considering that –

- it represents only a small part of the land owned by the Government and to report it in the Statement of Financial Position while ignoring all the others is rather inconsistent and misleading;
- whether or not this kind of land is valued and reported as assets does not affect the Government's financial performance because land values, unlike other fixed assets, need not be depreciated and charged to the Statement of Financial Performance as expenses; and
- it makes more sense to leave the subject of land valuation, a very costly and time-consuming exercise involving all sorts of

complexities and uncertainties, to be reconsidered in the post-implementation review in 2006-07 after an assessment has been made of the actual costs and benefits of reporting fixed assets in the Government's balance sheet. In addition, more definitive reference and guidance can be drawn by then from public sector accounting standards and the practices of overseas jurisdictions in the reporting of government land which, for the time being, remains a problem internationally and practices do vary significantly even among those jurisdictions where accrual accounting has been adopted.

Consolidation

14. One respondent finds the Task Force's arguments (i.e. impracticality and that the resultant consolidated accounts might not be meaningful to the users) against complying with the IFAC's consolidation standard unacceptable.

Our response

15. While the consolidation policies proposed by the Task Force are not entirely consistent with the IFAC's consolidation standard in terms of coverage and consolidation methods, the proposed coverage will be much wider than the existing Consolidated Account of the Government. The consolidation methods chosen by the Task Force can serve the purpose of reflecting the relationship between the Government and the entities being consolidated. In its submission to IFAC, the HKSA has pointed out that the IFAC's consolidation standard poses the question of practicality (too many entities to consolidate) and it is not obvious if a fully complying

consolidated picture would really help to give a better picture of the controlling entity and the controlled entities.

Accounting for Revenue and Expenditure on Cash Basis

16. Some respondents consider it necessary to report revenue and expenditure on the accrual basis in accordance with gaaps so as to achieve greater transparency.

Our response

17. The proposed reporting policy for revenue and expenditure is based on a number of factors. On the cost side, the amounts of cost and effort required to ascertain the accrual figures are likely to be considerable given the lack of accrual functionality in the existing accounting systems. On the benefit side, it would not make much difference even if revenue and expenditure are accounted on the accrual basis. When the new Government Financial Management Information System is implemented in the next few years, more accrual of revenue and expenditure should become achievable and the post-implementation review scheduled in 2006-07 will revisit this issue.

Threshold for Capitalisation of Fixed Assets

18. Some respondents find the capitalisation threshold of \$1 million for fixed assets too high – the threshold refers to the value below which items of fixed assets will not be reported in the balance sheet. While appreciating the Task Force's intention to minimise the costs and effort required to identify and value the vast numbers of existing fixed assets, one

respondent suggests that a lower capitalisation threshold should be adopted for fixed assets acquired after the introduction of accrual accounting.

Our response

19. We have revised our recommendations to use a lower capitalisation threshold (same as that for Capital Account expenditure, which is \$100,000 at present) for fixed assets acquired from 2002-03 onwards.

Changes to Original Proposals

20. We have considered the comments received and compiled the Task Force Report. Copies of the Report (both English and Chinese versions) are attached. It can be seen that we have modified the original proposals in the consultation document to take account of the public views –

- acknowledging as the Government's longer term goal that the accrual-based accounts should comply with IPSASs wherever it is appropriate and practicable to do so;
- accepting that consultations should be held with the Audit Commission on an early target date for audit of the accrual-based accounts and early audit involvement during the initial trial period;
- using a lower capitalisation threshold (same as that for Capital Account expenditure, which is \$100,000 at present) for fixed assets acquired from 2002-03 onwards; and
- agreeing to consider in the post-implementation review in 2006-07 –

- areas for greater compliance with IPSASs;
- the desirability and the practicality of accrual budgeting; and
- the need for legislative changes.

Publicity

21. We shall issue a press release and send copies of the attached Task Force Report to interested parties (mainly the Hong Kong Society of Accountants and its Council Members, Chambers of Commerce, the accountancy academics of local universities, and the parties who have made written submissions to us on the consultation document). Members of the public can access the Report through the websites of the Finance Bureau (named as the Financial Services and the Treasury Bureau (the Treasury Branch) after 1 July 2002), the Treasury and the Government Information Centre. Copies of the Report are also available from the Finance Bureau and the Treasury upon request.

Way Forward

22. We intend to implement the revised Task Force's recommendations as originally scheduled, publishing the first accrual-based Government Accounts in November 2003. The post-implementation review in 2006-07 will take stock of the results achieved and identify the scopes and opportunities for further changes.

23. In consultation with bureaux and departments in the course of detailed examination of their resource requirements, we have revised our assessment of the resources required as follows -

(a) a one-off implementation cost of \$49 million (of which \$45 million is for identification and valuation of buildings) to be incurred between 2002-03 and 2004-05; and

(b) an average annual recurrent cost of about \$9 million will be incurred for 2002-03 to 2004-05.

24. The recurrent cost is mainly attributable to the need to create a Central Advisory and Support Team consisting of seven officers at the Treasury to co-ordinate the implementation and see the project through. The provisions have been reflected in the 2002-03 Estimates and approved by the Legislative Council Finance Committee.

Finance Bureau and Treasury
June 2002