PREFACE

The objective of the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) is to develop programs aimed at improving public sector financial management and accountability. To that end, the IFAC PSC issues Guidelines, Statements on Practice and Studies. Studies are undertaken by the Committee to provide information that contributes to public sector financial reporting, accounting or auditing knowledge.

In March 1991, the IFAC PSC issued Study 1, *Financial Reporting by National Governments* and in July 1993, issued Study 2, *Elements of the Financial Statements of National Governments*. Study 1 considers the objectives of the financial reports of national governments and their major units, and the extent to which those objectives are met by different bases of accounting and different reporting models. Study 2 considers the identity and nature of the "elements" (that is, types or classes of financial information) of financial statements that might be prepared consistent with different bases of accounting and the "messages" communicated by financial statements which report those elements or subsets thereof.

This Study is a companion to PSC Studies 1 and 2. It considers what resources and which entities should be considered as part of national governments for financial reporting purposes.

This Study considers the implications of different approaches to the definition of the government financial reporting entity and different techniques for the construction of government financial reports to the achievement of the objectives of financial reporting identified in Study 1.

It is hoped that the Study, as with other IFAC PSC Studies, will contribute to debate and developments directed at enhancing the relevance, understandability and comparability of financial reporting by national governments and their major units.

The Government Financial Reporting Entity

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CHAPTER 1

IDENTIFICATION OF THE GOVERNMENT FINANCIAL REPORTING ENTITY

Purpose of this Study

.001 The purpose of this Study is to consider:

(i) how the government financial reporting entity may be defined for financial reporting purposes and the transactions, events and entities that may be encompassed within that financial reporting entity;

(ii) the ways in which the financial statements of different entities included in the government financial reporting entity may be combined; and

(iii) the implications of different definitions of the financial reporting entity for achieving the objectives identified in PSC Study 1, in particular, the usefulness of the messages communicated by financial statements to users.

By doing this, it is hoped that this Study will lead to improvements in financial reporting by governments and greater comparability of financial reports between and within different jurisdictions.

.002 PSC Study 1, *Financial Reporting by National Governments* (IFAC, 1991), and PSC Study 2, *Elements of the Financial Statements of National Governments* (IFAC, 1993) include definitions of “basis of accounting”, “elements of financial statements”, “financial reporting”, “financial reports”, “measurement focus”, “reporting model” and “financial statements”. Where these terms are used in this Study, they are to be read with the same meaning as defined in PSC Studies 1 and 2. Appendix 2 to this Study is a glossary which includes all terms defined in PSC Studies 1 and 2.

.003 In this Study the term “entity” refers to a legal, administrative or fiduciary arrangement, or other organizational structure or party which has the capacity to deploy resources in order to achieve objectives.

Scope of the Study

.004 This Study considers the following matters:

(i) the broad characteristics that reporting entities should possess; and

(ii) issues related to the application of these broad characteristics to determining the boundaries of a government financial reporting entity.

In relation to (ii), consideration is given to the criteria that can be adopted for determining the boundaries of a government financial reporting entity and the ways in which the financial statements of a government financial reporting entity can be combined.

.005 Consistent with PSC Studies 1 and 2, the primary focus of this Study will be on financial reporting by national governments. However, the matters it addresses may be equally applicable for other levels of government (state, provincial and local governments).

Nature of Reporting Entities — General Characteristics

.006 PSC Study 1 considers the objectives of financial reporting by national governments and their units. That Study notes that the overriding objective of financial reporting is to communicate reliable information which is relevant to the decision making and accountability needs of users. It also notes that the overriding objective can encompass a number of component parts; for example, communicating information about compliance with spending mandates, financing of activities, financial condition and various aspects of performance (see Appendix 1 for a full exposition of those component parts).

.007 Depending on the identity of the primary users of financial reports and their information needs, different components of the overriding objective identified by PSC Study 1 may be more or less relevant for particular reporting entities.

.008 If financial reporting is to be effective in ensuring adequate disclosure of information to meet users' needs, it is necessary that all those entities which should report, do report. In addition, if financial reporting is to be rational and efficient, it is equally important that those entities for which there is no justification to report are not required to report.

.009 Given that the objectives of financial reporting are developed within a framework which identifies users' information needs as primary, the identification of entities which should report is also related to users' information needs.

.010 This Study reflects a view that individual reporting entities may be defined by reference to the existence of users who are dependent on financial reports for information for accountability and/or decision making purposes. ("Financial reports" as used in this Study refer to general purpose financial reports — see the definition in the Glossary.) Reporting entities should prepare financial reports to disclose information consistent with users' needs, subject to the general constraint that the benefits to users of such information exceeds the costs of preparing it.

.011 Therefore, it is useful to determine a definition of a "financial reporting entity" to facilitate the task of governments in reviewing the adequacy of the rules used in the past to identify entities that should prepare general purpose financial reports. Some entities that are not presently required to report may be reporting entities. Some entities that are presently required to report may not be reporting entities. Consistent with the objective of financial reporting, the general philosophy that should be applied by governments is reflected in the following definition:

> "financial reporting entities" mean entities in respect of which it is reasonable to expect the existence of users dependent on financial reports for information which will be useful to them for accountability and decision making purposes.

.012 In the context of this Study, the definition only applies to the different tiers of government. However, the definition could be applied to departments or ministries of governments or other entities that carry out the functions of governments.

.013 In respect of most entities, it will be readily apparent whether there exist users who are dependent on financial reports as a basis for making and evaluating resource allocation decisions. In respect of other entities, it will be necessary to consider factors such as:

(i) the separation of management from those with an economic interest in the entity; and

(ii) whether users are likely to depend on financial reports for information for accountability and/or decision making purposes.

Consideration of factors such as the economic or political importance/influence of an entity and its financial characteristics (the extent of its resources and obligations) may also be relevant in determining whether it is likely that there are users dependent on an entity's financial report.

.014 This Study is concerned with defining the government reporting entity for financial reporting purposes. Consistent with Studies 1 and 2 it focuses on general purpose financial reports designed to meet the common needs of users external to the financial reporting entity. However, while concerned with financial reporting, it is important to recognize that reporting by public sector entities is likely to encompass non-financial information about service costs and achievements. This is because governments are accountable for the achievement of service delivery as well as financial objectives, and government priorities and policy decisions about the allocation of scarce resources will be influenced by the desire to achieve social and economic policy objectives, for example, health, welfare and macro-economic objectives. Frequently, the reports for a national government will be almost entirely financial in nature, while the reports of departments or ministries of government will include a great deal of non-financial information. However, governments may wish to address the non-financial aspects of their performance by including related information in their reports.

.015 The accounting systems that produce information for general purpose financial reports are also used to obtain information for the management of the government's operations. Accordingly, any assessment of the benefits of preparing general purpose financial reports in respect of the government reporting entity must factor in the benefits of management's use of the related information systems.

The Government as a Financial Reporting Entity

.016 PSC Study 2 is concerned with the way in which the financial effects of a wide and diverse range of transactions and other events could be grouped to enable financial statements to communicate effectively and economically. This Study addresses a different dimension of that problem — given that a government may operate through a number of different administrative, statutory and/or legal entities in the delivery of goods and services to their constituents, how can the government discharge its accountability in relation to the resources for which it is responsible?

.017 The public have a right to an accounting for the resources entrusted to their government. For this reason, governments are entities which should prepare financial reports. Those financial reports should disclose information to a potentially wide range of users for decision making and accountability purposes. Indeed all governments publish a plethora of financial reports about future plans and past performance. Those financial reports are general purpose in nature and are used by a wide range of users including members of the public, the media, elected bodies and special interest groups.

.018 This is consistent with the view of the accounting profession in a number of countries — that governments are reporting entities and should be required to prepare general purpose financial reports because:

(i) they command significant resources;

(ii) their use of those resources can have a significant impact on the social and/or economic well being of members of the community; and

(iii) there is a separation between management and ownership of those resources.

.019 There are two broad approaches that are used to identify government financial reporting entities.

.020 In some countries, for example Bangladesh, France, Italy and Taiwan many of the financial reporting entities are identified using rules that generally relate to the stewardship of public funds. Examples of these rules, which are generally established by governments via legislation, are outlined in Figure 1.1. In some cases, the rules provide explicit definitions or descriptions of financial reporting entities. In other cases, the rules imply that national and other governments are financial reporting entities by virtue of their stewardship of public funds.

.021 In other countries, for example Australia, Canada, New Zealand and the United States of America, underlying principles have been developed that provide guidance to help identify financial reporting entities. Examples of these principles, which are generally promulgated by the accounting profession in each jurisdiction, are outlined in Figure 1.2.

.022 The fact that governments should prepare general purpose financial reports raises a number of related issues such as:

(i) what entities and transactions should be reflected in the financial report of the government — that is, where should the boundaries of the government financial reporting entity be drawn;

(ii) should information about all the entities included within the boundaries of the government financial reporting entity be combined/merged or reported separately; and

(iii) if merged or combined reports are to be prepared, how should the combination or merger be achieved.

Figure 1.1

EXAMPLES OF RULES FOR IDENTIFYING REPORTING ENTITIES

COUNTRY	DOCUMENT	RULES
Bangladesh	Constitution of the Republic of Bangladesh, Chapter II — Legislative and Financial Procedures	There shall be laid before Parliament, in respect of each financial year, a statement of the estimated receipts and expenditure of the Government for that year. Therefore, the government reporting entity is determined by the amounts it receives and the payments it makes.
France	Constitution of 1958 — Financial law no. 59.2 (1959) — Rules on Public Accounting, decree no. 62.1578 (1962)	Reporting entities are primary governments and any other governmental organization which issues separate financial statements. The two main, distinct criteria are: (i) reporting for political accountability by executive government to a legislative body; and (ii) reporting for personal legal and financial responsibility by public accounting officers to the Court of Audit.
Italy	National Law no. 259 (1958) and no. 51 (1982)	Reporting entities are primary governments and any other governmental organization which issues separate financial statements. Reporting entities are also: (i) those bodies that receive, on a regular basis, and incorporate in their budget for more than two years, taxes, levies and contributions which they are authorized to impose on a permanent basis, or which are devolved to them. Contributions can be in the form of capital, services or assets or the granting of financial guarantees. In addition, a body receiving a contribution from such a reporting entity may itself be a reporting entity, depending on the size of the contribution and the nature of the activities of the body; and (ii) provinces and municipalities with more than 8,000 inhabitants, which are deemed to be reporting entities.
Taiwan	Budget Law Law of Accounting Annual Reporting Law Law of Audit	The central government, provinces, counties and towns are all deemed to be reporting entities.

Figure 1.2

EXAMPLES OF UNDERLYING PRINCIPLES PROVIDING GUIDANCE FOR IDENTIFYING REPORTING ENTITIES

COUNTRY	DOCUMENT	GUIDANCE/DEFINITION
Australia	Statement of Accounting Concepts SAC 1 "Definition of the Reporting Entity" (1990)	Reporting entities are all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources. (paragraph 40)
Canada	Public Sector Accounting Recommendations, Section PS 1300, "Financial Reporting Entity" (1996)	Federal, provincial, territorial and local governments are separate reporting entities and would be excluded from the financial reporting entity of any other government. (paragraph .02) Government financial statements should provide an accounting of the full nature and extent of the financial affairs and resources for which the government is responsible, including those related to the activities of government agencies and enterprises. (paragraph .03)
New Zealand	Statement of Concepts for General Purpose Financial Reporting (1993)	A reporting entity exists where it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them in terms of: (i) assessing the reporting entity's financial and service performance, financial position and cash flows; (ii) assessing the reporting entity's compliance with legislation, regulations, common law and contractual arrangements; and (iii) making decisions about providing resources to, or doing business with, the reporting entity. (paragraphs 2.1 & 3.1)
United Kingdom	Statement of Principles for Financial Reporting ASB.	A reporting entity should in principle prepare financial statements if there are potential users with a legitimate interest who rely on such statements as a major source of financial information about the entity (the demand condition). To be able to supply useful financial statements, an entity must be a cohesive economic unit, usually resulting from a unified control structure (the supply condition). In practice, legislation determines which entities are required to be reporting entities - for example, legislation in the UK contains financial reporting requirements for companies and groups.
United States of America	(a) Federal FASAB Statement of Federal Financial Accounting Concepts,	For any entity to be a reporting entity, it would need to meet each of the following criteria: (i) There is a management responsible for

COUNTRY	DOCUMENT	GUIDANCE/DEFINITION
	“Entity and Display” (1995)	controlling and deploying resources, producing outputs and outcomes, executing the budget or a portion thereof (assuming the entity is included in the budget), and held accountable for performance of the entity. (ii) The scope of the entity is such that its financial statements would provide a meaningful representation of operations and financial condition. (iii) There are likely to be users of the financial statements who are interested in and could use the information in the statements to assist them in making resource allocation and other decisions and holding the entity accountable for its deployment and use of resources.
	(b) State and Local GASB Statement No. 14 of the Government Accounting Standards Board “The Financial Reporting Entity” (1991) (State and Local Governments)	Reporting entities are primary governments and any other governmental organization when it issues separate financial statements. The foundation of a primary government is a separately elected governing body — one that is elected by the citizens in a general, popular election. A primary government is any state government or any general purpose local government (municipality or county). A primary government is also a special-purpose government (for example, a school district or a park district) that meets all of the following criteria: (i) it has a separately elected governing body; (ii) it is legally separate; and (iii) it is fiscally independent of other state and local governments. (paragraphs 12 & 13)

CHAPTER 2

BOUNDARIES OF THE FINANCIAL REPORTING ENTITY

Importance of Determining the Boundaries of the Financial Reporting Entity

.023 Determining the boundaries of a government financial reporting entity will determine which entities, transactions and activities will be encompassed by a government's general purpose financial report. The government reporting entity should be determined in a manner which enables the financial reports to provide a comprehensive yet understandable overview of government and its activities.

.024 While drawing the boundaries may be difficult, it provides an opportunity to identify and sharpen the focus on the activities that a government is responsible for and to clarify the roles and accountability of a range of public sector organizations. It is also recognized that inappropriate delineation of the boundaries of the government financial reporting entity would have adverse consequences on the messages communicated by the financial report and the discharge of the accountability obligations of a government.

Relationship to Objectives of Financial Reporting

.025 The nature of the entities, transactions and events that should be encompassed by the financial report of the government should be determined by reference to the objective of financial reporting. The objective of financial reporting should in turn be determined by reference to perceptions of the likely nature of users' information requirements.

.026 As noted in PSC Study 1, the overriding objective of financial reporting is the disclosure of information for accountability and decision making purposes. PSC Study 1 also notes that, depending on the identity of users and their information needs, different components of the overriding objective may be more or less relevant.

.027 In practice, there is a widespread acceptance that financial information should be prepared for accountability and, perhaps, to a lesser extent, decision making purposes. However, it is evident that there are, at least, two distinct views about how to determine the boundaries of the financial reporting entity in order to best satisfy the need for information for accountability and decision making purposes.

.028 One view is that accountability and the provision of information for decision making can be met by demonstrating compliance with the authorized allocation of funds or spending mandates, for example, demonstrating compliance with expenditures authorized to be made from “consolidated revenue” or “public funds”.

.029 An alternative view is that accountability and the provision of information for decision making is best met by reporting on all of the resources for which the government is responsible, in addition to reporting on compliance with spending mandates. This may mean that the government financial reporting entity includes all those entities and transactions which the government controls or owns. The distinction between “control” and “ownership” is discussed in a later section of this Study.

.030 Where the criterion for determining the government financial reporting entity is compliance with the authorized allocation of funds, identification of the authorized allocations themselves will determine the transactions to be encompassed by the financial reporting entity. In such cases, the government financial reporting entity can be determined by reference to legislation and other authority and there may be only limited need for judgement.

.031 Where the criterion for determining the government financial reporting entity is control or ownership, relatively more judgement may be required.

Compliance with the Authorized Allocation of Funds as the Determining Criterion

.032 As indicated in Figure 2.1, the predominant criterion used to determine the boundaries of a government financial reporting entity is compliance with the authorized allocation of public funds, sometimes termed "spending mandates". That is, the boundaries of the government financial reporting entity are drawn to encompass entities, and reflect transactions, which are funded wholly or predominantly by authorized allocations of public funds. The entities and transactions are sometimes referred to as the "budget sector", on the basis that the government authorizes the allocation of public funds through a "budget" on an annual or more frequent basis.

The "Budget Sector" and the "Non-budget Sector"

.033 In most jurisdictions, government is considered to comprise two components, often referred to as the "budget sector" and the "non-budget sector".

.034 As noted above, the budget sector includes those entities and transactions that are funded wholly or predominantly by authorized allocations of public funds. This would include government departments or ministries and possibly other administrative entities established under legislation and transactions relating to allocations of public funds to non-government entities, such as privately managed medical or educational entities.

.035 The non-budget sector would normally encompass entities or activities that are completely self-funding or are dependent on government for only a limited amount of funding. This would usually include government owned or controlled commercial entities such as government business enterprises that are corporations or other legal or administrative entities, which may operate in the energy, water, communications, agricultural-marketing, banking and insurance industries.

Support for Using the Authorized Allocation of Funds as the Determining Criterion

.036 It can be argued that compliance with the authorized allocation of public funds is the most relevant criterion for determining the boundaries of a government financial reporting entity because users are interested in knowing whether, and how efficiently, the policies of government with respect to the allocation of public funds have been carried out.

.037 Furthermore, it can be argued that, because users who are interested in the activities of entities that are part of the non-budget sector can obtain relevant information from the separate financial reports of those entities, it is most appropriate for the government financial reporting entity to consist only of the budget sector. A different, but related argument, is that the activities conducted in the budget sector are dissimilar from the activities conducted in the non-budget sector and, therefore, they should not be treated as forming part of a single reporting entity. That is, for example, the activities undertaken in the budget sector are non-commercial and the activities undertaken in the non-budget sector are commercial in nature. It should be noted, however, that the disaggregated display of information in the financial reports of governments can be used to highlight differences in the budget and non-budget sectors.

.038 In some jurisdictions, it is argued that it is appropriate to use a cash or modified cash basis of accounting for the budget sector, while an accrual basis of accounting is appropriate for entities in the non-budget sector. Therefore, it is inappropriate, and indeed impracticable, to consolidate the financial information for the two sectors.

Inadequacies of Using the Authorized Allocation of Funds as the Determining Criterion

.039 Determining the boundaries of the government financial reporting entity is central to the achievement of the objectives of financial reporting. If the matters for which a government is and is not accountable are not clear, it cannot be effectively held to account. The use of the authorized allocation of funds as the criterion for determining the boundaries of the government financial reporting entity may lead to a number of inadequacies in a government financial report.

.040 In some jurisdictions, the budget sector will represent virtually all of the activities of government and it may be plausible to argue that it is the proper focus for attention. However, most governments have organizational structures that include non-budget sector entities and by using the authorized allocation of funds as the criterion for determining the government financial reporting entity, a government's financial report will potentially provide only a fragmented view of the resources and obligations for which the government is accountable.

.041 While non-budget sector entities do not generally rely on public funds for their continued operation, governments are ultimately accountable for these entities and their transactions. In addition, at particular times the government may have to support non-budget entities financially or, alternatively, may extract resources from non-budget sector entities which are needed to fund other government programs. Therefore, a major inadequacy with using the authorized allocation of funds as the criterion for determining the government reporting entity is that it will result in the financial report not reflecting all of the entities and transactions for which government is accountable. A further inadequacy of the authorized allocation of funds determining the government reporting entity is that it reports only the transfer of funds to and from government owned or controlled organizations which are considered outside the budget sector. Therefore, it fails to provide the information necessary to assess whether the use of those funds complies with legislative intentions and other externally imposed requirements after the year in which the funds have been spent.

.042 Under the authorized allocation of funds approach to determining the government reporting entity, the financial impact of activities in entities are only recognized in the government reporting entity in years during which funds flow either to or from the entity. As the government can control the timing of those fund flows, it can influence the impact on the financial statements in any given year. This would be detrimental to the comparability of a government's financial reports. It would be desirable for the boundaries of the government reporting entity to be determined in a way that minimizes the scope for governments to present information that does not show a reliable picture of the entities and transactions for which they are accountable. However, where the boundaries of the government financial reporting entity are drawn to encompass only those entities, and reflect only those transactions, which are funded by authorized allocations of public funds, there will be many opportunities for governments to adjust the results of their activities. This is because governments will be able to transfer funds between the budget sector and entities the government owns or controls but which fall outside those boundaries. For example, governments may operate separate entities that are monopoly providers of services, such as transport or water, which would be able to set prices to meet government policy. That is, the prices that consumers of transport or water are charged may reflect not only the cost of providing the transport or water but could, for example, also reflect a component to fund other activities of government. This component, which could be varied from one reporting period to the next, could be recognized as a revenue or receipt in relation to the budget sector at the discretion of the government.

.043 In view of the above inadequacies, it is often argued that the provision of information for accountability and decision making purposes cannot be achieved by a general purpose financial report that merely reports on compliance with the authorized allocation of funds.

Control/Ownership as the Determining Criterion

.044 As identified in PSC Study 1, it is recognized that there is a spectrum of accounting bases, from the cash basis to the modified accrual and accrual bases. The implications for the recognition of assets, liabilities, revenues and expenses under the various bases of accounting is addressed in PSC Study 2. The many references in this section of this Study to "resources" and to "obligations" should be read as potentially encompassing all of the different accounting bases. Such references should also be read as relating to changes in resources and obligations, being expenses/expenditures and revenues/receipts.

.045 As indicated in Figure 2.1, a number of pronouncements issued by the accounting profession in some jurisdictions have identified control or ownership of entities as the criterion that should be used to determine the boundaries of the government financial reporting entity.

.046 There are a variety of concepts of control, including those based on risks and/or benefits, and accountability. The concept of ownership, whilst appearing more objective, can also be open to a number of interpretations, particularly in the public sector where ownership of resources and entities is not always clear-cut. In most cases, the boundaries of the financial reporting entity will be the same whether a criterion of ownership or control is adopted. However, in the context of this Study, "control" and "ownership" are considered to be potentially different. In some circumstances, resources or entities may be controlled but not owned and, less commonly, resources or entities may be owned but not controlled. This is because ownership is generally determined from the legal form of entities and transactions, whereas control is normally applied as a concept without regard to legal form. That is, under the control criterion, the boundaries of the government financial reporting entity will be determined so as to include all of the resources it controls and all of its obligations, no matter what administrative or legal entities have been created to facilitate management of those resources and obligations.

Control or Ownership

.047 In general, those who support the use of control, rather than ownership, for determining the boundaries of the financial reporting entity argue that the use of control is more consistent with the objective of financial reporting. This is because governments should be accountable for the entities and resources that they control and should not be accountable for the resources and entities that they do not control. That is, control carries with it an obligation to be accountable, while there is no sense in a government being made accountable for entities and resources that it does not control. Similarly, governments should be accountable for the obligations for which they are responsible.

.048 The usefulness of messages conveyed by the financial report about a government's resources and obligations, however those resources and obligations are defined, is undermined if the financial reports include resources that the government does not control or obligations for which the government is not responsible. Similarly, those messages are undermined if resources which the government controls or obligations for which it is responsible are excluded from the financial report.

.049 The movement along the spectrum from cash to accrual accounting discussed in PSC Study 2, and the reporting of controlled resources, are consistent with the adoption of financial reporting objectives that acknowledge that to discharge their accountability obligations, governments should report on all the resources they control, all of the obligations for which they are responsible, and the results of their management of those resources and obligations. The basis of accounting adopted will determine the nature of those resources and obligations.

.050 Similarly, for decision making purposes, information about resources controlled and changes in those resources during the reporting period should be communicated to users. Messages about the financial position and performance of governments would be distorted if these messages reflected resources and changes in resources that the government does not control or, conversely, if they exclude resources that the government does control.

.051 There are difficulties associated with applying any criterion for determining the government financial reporting entity. Some may argue that the concept of control is not appropriate because governments can potentially control all of the resources within their sovereignty through their powers to tax and regulate. Use of the power to control via regulation would clearly give rise to a government financial reporting entity of meaningless dimensions. However, there are other forms of control and standard setters have generally focussed on control in relation to financial and operating policies, which, in some jurisdictions, has provided a workable model for use in both the private and public sectors. Definitions of control are discussed later in this Chapter.

.052 While the use of the criterion of control would mean that the government financial reporting entity would extend beyond the budget sector, it is noted in Chapter 3 that practical considerations may lead to separate financial reports being prepared for the budget sector and non-budget sector.

Concept of Control

.053 Most of the definitions of control adopted by the standard setting organizations shown in Figure 2.2 are applied primarily in the private sector. Nevertheless, the fact that in some jurisdictions a common definition is applied in both the private and public sectors, indicates that the relevant concepts can be applied to the public sector.

.054 The definitions of control shown in Figure 2.2 generally exhibit one common characteristic, being governance of financial and operating policies for the controller's purposes. Secondary characteristics common to a number of the definitions are that the government is entitled to enjoy the benefits from an entity's net assets and is exposed to the financial risks facing an entity, which are factors generally given less prominence in the public sector than in the private sector.

.055 Governments may establish separate entities to carry out government programs or they may establish administrative arrangements, such as departments or ministries, for this purpose. The concept of control should be applicable regardless of the "vehicle" used to carry out the government's programs. Due to the private sector focus of most of the definitions in Figure 2.2, they relate more to circumstances where separate entities have been established. However, the concepts can also be applied to separate entities and administrative arrangements of government. This is the case, for example, in Australia and New Zealand.

.056 The concept of control does not necessarily depend on the existence of funding from government to an entity that delivers services on behalf of the government. For example, private schools or private hospitals may receive government grants without being controlled by the government. The government should ensure that the school or hospital is accountable for the provision of education or health services relating to the funding provided, but the government is not actually accountable for the private school or hospital, unless they are controlled entities. That is, funding alone does not provide the basis for control by a government. Involvement in the financial and operating decision making level would also need to be present to establish the necessary accountability relationship.

.057 A government's control of some of the individual assets of another entity and/or a responsibility to meet some or all of the individual liabilities of another entity should not necessarily be equated to control of the other entity. For example, a government may enter into an arrangement with another entity for the construction of an infrastructure asset and the delivery on behalf of the government of services associated with that asset. Where the ownership of the asset initially resides with the other entity but reverts to the government at some specified point of time in the future, the government may have an asset in the form of the right to receive the infrastructure in the future. However, this does not necessarily mean that the government controls the entity and should recognize all of the assets, liabilities, revenues and expenses of that entity in its consolidated financial statements.

.058 Most definitions of control require that the capacity to control must be "presently exercisable". A need to amend legislation or introduce new legislation indicates that a government does not presently possess the capacity to control another entity. This is because the ability or power is not "presently exercisable" by the executive government, since it requires the assent of the legislature before the capacity to control is achieved. This restriction on the definition of "capacity" ensures that a government's wide-ranging powers to regulate the behavior of entities by using its legislative powers does not mean that the government is considered to control, for financial reporting purposes, all entities in respect of which it could potentially legislate control.

.059 Governments have the power to regulate the behavior of many entities by use of their legislative powers. To ensure that governments' financial reports include only the resources of entities about which it can make allocation decisions, the meaning of control for financial reporting purposes should not be interpreted so widely so as to include those entities that are merely:

(i) conducting activities within a regulatory framework established by the legislature. The power of the legislature to establish the regulatory framework within which entities operate and to impose conditions/sanctions on their operations does not normally constitute control by a government of the assets deployed by these entities. It is important to distinguish between the capacity of the legislature to legislate and influence the financial and/or operating policies of a wide range of entities, from the capacity of the executive government and ministers to make policy decisions regarding the deployment of the assets of entities; or

(ii) funded by, or economically dependent on a government. For control to exist, a government must have the capacity to determine both the financial and operating policies, and thus deploy the assets of the entity, without relying on the voluntary co-operation of others. For example, a government may be able to influence the financial and operating policies of an entity which is dependent on government funding (such as a charity) or a profit-oriented entity that is economically dependent on business from the government. However, where an entity retains discretion as to whether it will take funding from or do business with the government, that entity has the ultimate capacity to determine its own financial or operating policies and, accordingly, is not controlled by the government.

Applying the Concept of Control

.060 The existence of control will depend on the facts in each case. For practical reasons, the application of the concept of control for financial reporting by governments will probably require the establishment of rules or guidance so that consistent decisions can be made in respect of a range of entities and activities.

.061 Any of the following factors would normally indicate the existence of control by a government of another entity:

(i) the existence of an executive power which enables the government to give directions to the governing body of that entity on its financial and operating policies;

(ii) the government has broad discretion, under existing legislation, to remove a majority of members of the governing body of that entity; or

(iii) the government has a majority of the votes that are likely to be cast at a general meeting of that entity.

.062 The existence of an Executive or other power which enables a government to give directions to the governing body of another entity indicates that the government has the capacity to dominate the financial and operating decisions of that other entity so as to enable that other entity to operate with it in pursuing the government's objectives.

.063 The following are some factors that may indicate that a government has an Executive or other power of direction over another entity:

(i) the government has the ability to veto operating and capital budgets of the entity;

(ii) the government has the ability to dissolve the entity under existing legislation;

(iii) the government is exposed to the residual liabilities of the entity;

(iv) the government has the right to receive a majority of the net assets of the entity if the entity is dissolved;

(v) the mandate of the entity is established, and limited, by legislation;

(vi) the government has the capacity to appoint the chief executive officer (or equivalent) of the entity;

(vii) the entity must comply with the reporting requirements set out in legislation concerned with financial reporting and/or the audit of "public sector" entities;

(viii) the entity is required to submit financial reports to a member of the Executive and those reports are required to be tabled in the legislature; or

(ix) the employees of the entity are employees of the state.

.064 The factors listed above need to be evaluated in the light of other prevailing circumstances. For example, a marketing board whose mandate is created, and limited, by legislation is not controlled by a government if the legislation assigns, unequivocally, the capacity to dominate financial and operating policies to other entities such as relevant commodity producers, and the government does not have the capacity to remove a majority of members of the governing body.

.065 The capacity of a government to remove a majority of members of the governing body of another entity indicates that the governing body cannot maintain financial and operating policies that do not have the approval of the government. This means that, in substance, the government has the capacity to dominate the financial and operating policies so as to meet its own objectives.

.066 If the capacity to remove a majority of members of the governing body requires an amendment to the current legislation or the creation of new legislation, then the government's power is not presently exercisable and control does not exist. A capacity by the government to remove a majority of the members of the governing body of another entity and consequent control over that entity can only exist where the government has broad discretion over the removal of members. This means that where, for example, the capacity of the government to remove members of the governing body of another entity only arises under certain restricted circumstances (for example, an ability to remove members only for reasons of lack of probity), the government would not have the capacity to dominate the financial and operating policies of that entity and accordingly, the government would not control that entity.

.067 Where a government has a majority of the votes that are likely to be cast at a general meeting of another entity, it would be able to veto any financial and operating policies that are not in accordance with its own objectives. Where a government holds a majority ownership interest, this would normally indicate that the government has a majority of the voting rights.

.068 A government must have the capacity to deploy the resources of another entity in pursuit of its own objectives for control over that entity to exist. Depending on the nature of the resources of the entity, control over those resources by a government implies that it can exchange them, use them to provide goods or services, exact a price for another entity's use of them, use them to settle liabilities or hold them.

.069 The existence of control in the context of general purpose financial reporting does not necessarily indicate that there is also control over the manner in which professional functions are performed by an entity. For example, whilst a government controls the amount of resources controlled by judicial or other statutory offices, and establishes broad parameters within which those resources can be deployed, those offices are accountable to the legislature and are not subject to the directions of the government as to the manner in which they discharge their statutory functions.

Figure 2.1

CRITERIA FOR IDENTIFYING THE BOUNDARIES OF THE GOVERNMENT FINANCIAL REPORTING ENTITY [1]

GOVERNMENT OR ACCOUNTING PROFESSION AUTHORITATIVE PRONOUNCEMENTS/EXPOSURE DRAFTS

COUNTRY	DOCUMENT	BROAD CONCEPT	REPORTING IMPLICATIONS
Australia	Statements of Accounting Concepts SAC 1 "Definition of the Reporting Entity" (1990); and SAC 2 "Objective of General Purpose Financial Reporting" (1990); and ED 62 "Financial Reporting by Governments"	Accountability and Decision Making	All resources/entities controlled
	Commonwealth government — Audit Act 1901	Commonwealth government — budget dependency	Commonwealth government — entities that are largely budget dependent
	State (provincial) government (New South Wales[2]) — Public Finance and Audit Act 1983 and Regulations and Treasurer's Instructions	State (provincial) government — accountability and decision making	State (provincial) government — all resources/entities controlled
	Local (municipal) government — Regulations established in each State (province)[3]	Local (municipal) government — accountability and decision making	Local (municipal) government — all resources/entities controlled
Bangladesh	Constitution of the Republic of Bangladesh	Budget dependency	Entities that are largely budget dependent
Canada	Public Sector Accounting Recommendations, Section PS 1300, "Financial Reporting Entity" (1996)	Accountability, and ownership or control	Entities owned or controlled where the entity is accountable to government for the administration of its financial affairs and resources (paragraph .07)
France	Rules on Public Accounting, decree no. 62.1587 (1962) and Law on the Court of Audit, Law 67.483 (1967)	Accountability	Entities that are publicly funded
Italy	National Law no. 259 (1958) and no. 51 (1982)	Accountability for budget expenditures and decision making	Entities to which public funds are contributed on a regular basis
Mexico	National Law[4]	Accountability	Budget dependency

COUNTRY	DOCUMENT	BROAD CONCEPT	REPORTING IMPLICATIONS
Netherlands	National government — Accountability Law ("Comptabiliteitswet") Regional (provincial) government — Provincial Law Local (municipal) government — Municipal Law	National government — accountability for budget expenditures Regional (provincial) and local (municipal) governments — control and ownership	National government — entities that are largely budget dependent Regional (provincial) and local (municipal) governments — all resources/entities owned or controlled
New Zealand	Statement of Concepts for General Purpose Financial Reporting (1993) Public Finance Act 1989	Accountability and, to a lesser extent, decision making Ownership, defined so as to include aspects of control	All resources/entities owned by reference to "control" or "significant influence"
Portugal	Constitution of the Portuguese Republic and State Appropriation Acts	Accountability for budget expenditures	Entities that are largely budget dependent
United States of America[5]	(a) Federal Statement of Federal Financial Accounting Concepts No. 1 "Objectives of Federal Financial Reporting" (1993) and No. 2 "Entity and Display" (1995) (b) State and Local Statement No. 14 of the Governmental Accounting Standards Board "The Financial Reporting Entity" (1991)	Accountability and stewardship Financial accountability, determined on the basis of a number of conditions amounting to a notion of control	All organizations and programs listed in the budget as "Federal Programs" including off-budget accounts and other component entities that carry out federal functions, are owned or controlled, or there is financial interdependency. Entities/resources for which government is financially accountable
Taiwan	Budget Law Law of Accounting Annual Reporting Law Law of Audit	Accountability for budget expenditures	Entities that are largely budget dependent

1 Where relevant and useful, this Figure contains information relating to governments at the provincial/regional and local/municipal level as well as to national governments. Many of the same requirements also apply to component units of government which issue separate financial statements.

2 The reporting requirements vary as between each of the States and Territories (provinces) in Australia. New South Wales is further advanced than the other jurisdictions in developing its financial reporting framework, while the other jurisdictions are pursuing similar strategies.

3 The reporting requirements for local (municipal) governments in Australia are established separately by each of the States and Territories (provinces). They all effectively provide legal status to Australian Accounting Standard AAS 27 "Financial Reporting by Local Governments".

4 The relevant Mexican National Law includes: Ley Orgánica de la Administración Pública Federal, Ley de Ingresos de la Federación, Ley de Presupuesto, Contabilidad y Gasto Público, Presupuesto de Egresos de la Federación, Ley Federal de las Entidades Paraestatales and Principios de Contabilidad Gubernamental.

5 In the United States of America, the GAO, the Treasury Department and the Office of Management and Budget have the authority to establish accounting and reporting requirements for the federal government, and the GASB has authority to establish standards in respect of state and local governments.

In relation to the national jurisdictions referred to in Figure 2.1, a number require the boundaries of the government financial reporting entity to be drawn widely to encompass all activities which the government controls, whether or not the term "control" is used. In addition, the concept is used at other levels of government as in the cases of Australia and the Netherlands. In addition, Lüder (1989, pages 33, 34) notes that:

(i) in some US and Canadian States, and Denmark, the reporting entity, irrespective of the accounting basis adopted and the form of reporting (consolidated statement or not), includes all entities, commercial or otherwise, legally separate or not;

(ii) France, Germany, UK, Austria and the Swiss cantons tend to include all entities, whether commercial or not, that are not legally separate organizations.

Figure 2.2

PROFESSIONAL REQUIREMENTS/GUIDANCE ON THE DEFINITION OF OWNERSHIP/CONTROL

COUNTRY	DOCUMENT	APPLICATION	DEFINITION
Australia	Australian Accounting Standard AAS 24 "Consolidated Financial Reports" (1992); and ED 62 "Financial Reporting by Governments"	All reporting entities in the private and public sectors (when taken together with its corporate equivalent)	Control means the capacity of an entity to dominate decision making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity (paragraph 18, AAS 24)
Canada	CICA Handbook Section 1590, "Subsidiaries" (1992) Public Sector Accounting Recommendations, Section PS 1300, "Financial Reporting Entity" (1996)	Parent entities that are profit-oriented enterprises Parent entities that are governments	Control of an enterprise is the continuing power to determine its strategic operating, investing and financing policies without the co-operation of others (paragraph .03) A government controls an organization when ,without requiring the consent of others or changing existing legislative provisions it has the authority to determine the financial and operating policies of that organization. The authority of a government to determine the financial and operating policies of an organization allows it to establish the fundamental basis for the conduct of the organization's financial affairs, as well as the deployment of its resources. (paragraph .14)
International Accounting Standards Committee	IAS 22 "Business Combinations" (1993)	Parent entities that are business enterprises	Control is the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. (paragraph 9)
Italy	Constitution of the Republic of Italy (article 100), National Law no. 20 of January 1994 on Corte dei Conti Control Function Reforms and National Law no. 259 of March 1958	Public sector entities	Control is achieved in four ways: (i) in preventing some types of administrative acts (for example, convention or contract approval); (ii) subsequent control of administrative acts or activities; (iii) management control of administrative activities; and (iv) final budget control on public service reports and on out-of-budget management reports. Control means the power of an Auditing Authority to verify if administrative acts are in accordance with laws and other provisions and in relation to entities' financial and operating policies.

COUNTRY	DOCUMENT	APPLICATION	DEFINITION
New Zealand	Statement of Standard Accounting Practice No. 8 “Accounting for Business Combinations” (1990)	All types of parent entities excluding the Crown	Control means the power to govern the financial and operating policies of another entity for the purpose of obtaining the benefits and/or assuming the risks normally associated with ownership (paragraph 3.6)
Taiwan	Budget Law Law of Government Enterprise Management Central Government and Special Fund Management Standards	Government in relation to government business enterprises	An entity is under the control and supervision of the government if the government owns 50% or more of the paid up capital
United Kingdom	Financial Reporting Standard 2 “Accounting for subsidiary undertakings” (1992)	Parent undertakings in the private sector	The ability of an undertaking to direct the financial and operating policies of another undertaking with a view to gaining economic benefits from its activities (paragraph 6)
United States of America	Statement of Federal Financial Accounting Concepts No. 2 “Entity and Display” (1995)	Federal sector	Ownership is established by ownership of the organization, not just the property and by considering who is at risk if the organization fails, or identifying for whom the organization's employees work. Control may be revealed by (1) the ability to select or remove governing authority or to designate management, especially if there is a significant continuing relationship with respect to carrying out important public functions, (2) authority to review and modify or approve (a) budget requests, adjustments, or amendments or (b) rate or fee changes, (3) ability to veto, overrule, or modify governing body decisions or significantly influence normal operations, (5) approval of hiring, reassignment, and removal of key personnel, (6) title to, ability to transfer title to, and/or exercise control over facilities and property, and (7) the right to require audits that do more than just support the granting of contracts.

Degrees of Control and Significant Influence

.070 In some jurisdictions it is considered that there can be degrees of control. Under the accounting standard in the United Kingdom (1992), where one entity has “dominant influence” over another entity, the two entities should be consolidated on a line-by-line basis and where one entity has “significant influence” over another the equity method of accounting is employed. A similar position is adopted in the accounting standards in relation to profit-oriented entities in the private and public sectors in Canada (1991), and in the private sector in the United States of America (1971) and New Zealand (1990). The equity method of accounting involves recognizing a relevant share of the influenced entity's results in the operating statement of the “investor” and a share of the net assets in the statement of financial position of the “investor”.

.071 Under the Australian standard (1992), where the definition of control is met, a line-by-line consolidation is required and the equity method of accounting is not permitted, other than in respect of additional disclosures in the financial report. The view is that entities or activities are either controlled or they are not, and there should be no recognition of entities or activities that are not controlled.

Trusts

.072 Governments may operate administrative and organizational structures to manage commercial and non-commercial activities, and may operate one or more trust funds for the administration of a number of programs.

.073 In many cases, a government acts as a trustee for a range of trusts whereby the government controls the assets of the trust and can deploy those assets to meet its objectives. Examples of such trusts are those established and funded by, or in conjunction with, other governments or other entities for emergency relief where the government is charged with the responsibility for the allocation of those funds. Trusts controlled by the government form part of the financial reporting entity where the boundaries of that entity are established by reference to a control criterion.

.074 In other cases, a government may have legal custody of resources, and/or be able to dominate the financial and operating policies of another entity, without controlling them because it cannot benefit from the deployment of the resources or the other entity's assets. This would be the case where the government holds monies in trust for private individuals, acts as a collector or distributor of monies for other entities, or acts as a trustee for disaster relief funds or other funds, but other entities control the ultimate deployment of those monies. In some cases, the superannuation or retirement benefits of government employees may be maintained in a trust and governments may have only limited access to the funds in the trust.

.075 Information about resources which the government collects or distributes on behalf of another entity, and resources that the government has legal custody over but does not control, may be relevant for accountability and performance evaluation purposes and can be included as supplementary disclosures in the financial report. However, such resources should not be recognized in the financial statements of the government. Accountability obligations in respect of those trusts would be discharged by the preparation of special purpose reports for relevant parties and by disclosure in the financial report of a government.

.076 Lüder (1989, page 34) notes that few governments included in his study would include fiduciary or trustee responsibilities, such as pension plans, within the reporting entity.

Issues Relating to the Concept of Control

.077 If control is adopted as the criterion for establishing the boundaries of the government financial reporting entity, the following major issues would need to be resolved in each jurisdiction:

(i) at the policy level:

(a) determination of the definition/characteristics of control; and

(b) identification of the entities which are controlled by governments; and

(ii) at the technical level, the mechanism for combining all transactions.

.078 Where control is adopted as the criteria for determining the boundaries of the government reporting entity, the ultimate objective is to produce a financial report for the government and all of its controlled entities, in order to provide a comprehensive overview of the assets controlled and liabilities incurred by government and the revenues and expenses arising therefrom. However, in the short/medium term, practical difficulties (such as the elimination of inter-entity transactions when preparing consolidated financial reports) may inhibit this objective

.079 Clearly, it is not the role of this Study to identify which entities are controlled by the governments in different jurisdictions. That is the role of each government, after consideration of their relationship with the entities established to manage government resources and obligations and to deliver services. Governments should consider the suitability of definitions adopted by the accounting profession in their country and should encourage the accounting profession to harmonize the definition of control across all jurisdictions. Figure 2.2 shows the definitions adopted in a number of jurisdictions.

CHAPTER 3

COMBINED FINANCIAL STATEMENTS

Introduction

.080 The government financial report may encompass a number of entities which prepare financial statements in their own right. A number of techniques exist for combining separate financial statements, for example:

(i) separate financial statements for each of the entities/funds that are operated by the government;

(ii) separate financial statements for "groups" of funds or entities merged to reflect "sectors" or common characteristics;

(iii) merging the financial statements by:

(a) full consolidation of all entities;

(b) full consolidation of some and equity accounting of others; and

(c) simply combining.

Fund Accounting and Grouping of Fund Types

.081 As noted in Chapter 2 of this Study, traditionally, the focus of financial reporting by government has been on identifying the purposes for which expenditure has been authorized and demonstrating that those authorizations have been complied with. The government financial reporting entity has been determined by reference to the individual funds, for example, consolidated revenue fund, loan funds and other funds subject to parliamentary appropriation. The government financial report has been limited to reporting on compliance with those authorities and the basis of accounting adopted has been one that reflects the basis of appropriation — namely, expenditure from particular accounts or funds. In a number of jurisdictions, in recent times, this has been supplemented with the disclosure of information about assets and liabilities.

.082 Fund accounting is an accounting system structured to treat restricted assets as a separate accounting and, in many cases, financial reporting entity. On this basis, funds represent a pool of resources set aside for the carrying on of specific activities or attaining certain objectives in accordance with legislative or other regulatory restrictions placed on the use of those resources. By accounting for the resources on a separate or fund-by-fund basis, the extent to which resource usage has complied with those restrictions can be demonstrated. Lüder (1989, page 19) notes that in North American jurisdictions during the recent past "*the number of funds has in tendency been diminished* ".

.083 In state and local governments in the United States of America, a fund basis of reporting has previously been recommended by the National Council on Governmental Accounting (NCGA):

"*the primary reporting entity focus of separately issued GPFS (General Purpose Financial Statements) should be on the fund type and account group financial information*" (NCGA Statement 1, 1979, page 25).

.084 However, the Governmental Accounting Standards Board (GASB), which adopts a broad view of the activities and organizations which should be reported, advocates the preparation of reports made up of a number of reporting entities representing fund types:

"*GASB research on the entity indicated that users of governmental financial reports felt that the fund-type reporting approach in NCGA Statement 7 tended to obscure the financial data of the oversight government itself. The GASB studied both the definition and the reporting approach, and in June 1991 issued GASB Statement 14 on the entity. There is now clear distinction between the data pertaining to the legally constituted primary government and the data pertaining to the legally separate organizations for which the primary government is financially accountable. This reporting approach is a major departure from the traditional fund-*

type reporting." (Ives, Government Accountants Journal, Fall, 1992, page 3)

.085 The GASB approach requires reporting on a fund basis as well as on a summary basis. In addition, while drawing the boundaries of the financial reporting entity very widely, the GASB notes:

"*The financial statements of the reporting entity generally should allow the users to distinguish between the primary government and its component units by communicating information about the component units and their relationships with the primary government rather than creating the perception that the primary government and all of its components are one legal entity."* (GASB, 1991, page 4)

The approach then notes that because "*of the closeness of their relationship to the primary government, some component units should be blended as though they are part of the primary government; however, most component units should be discretely presented* " (GASB, 1991, page 17). Component units are "*legally separate organizations*" included within the financial reporting entity. "*Discrete presentation entails reporting component unit financial data in a column(s) separate from the financial data of the primary government. The reporting entity's combined balance sheet should include one or more columns to display the combined balance sheets of the discretely presented component units*" (GASB, 1991, page 18).

.086 It should be noted that GASB recently issued a Preliminary Views document (October 1995) that proposes a new financial reporting model. This model will have a dual perspective. It would keep the fund accounts perspective but would add an entity-wide perspective not currently available. The entity-wide perspective would continue the distinction between the primary government and component units but would report these amounts as consolidated totals with the elimination of interfund balances and transactions. The entity-wide perspective would use accrual accounting with a focus on economic resource flows. The fund perspective would continue to focus on current financial resource flows to report on the control of, and accountability for, raising and spending public moneys.

.087 With respect to the Federal Government in the United States of America, Statement of Federal Financial Accounting Concepts "Entity and Display" (1995) will result in a wide view of the government reporting entity, with consolidation of departments, independent agencies and government corporations, but excluding the Federal Reserve system. Consideration will also be given to reporting separate information significant components in the consolidated report, accompanying footnotes or separate reports.

.088 The approaches adopted by governments in Australia involve reporting on a funds basis for compliance purposes and the preparation of balance sheets and other financial statements to provide information about assets, liabilities and changes therein. These financial statements enhance accountability and evidence additional aspects of the governments' financial condition and management of resources.

Consolidated Financial Reporting Approaches

.089 There is a range of combination approaches, including among others simple combination, the equity method and full (line-by-line) consolidation. Lüder notes that the full range of alternatives was adopted by countries which he studied.

.090 In 1985 (GAO Review, 1985) Professors Orme and Smith advocated the preparation of consolidated financial statements for the US government. They noted that "*outsiders have real problems understanding current federal financial reporting*" based as it was on a number of funds. They also noted that the preparation of a consolidated financial report "*would expand financial reporting so that taxpayers, banks and other outsider users of the financial statements could see the overall condition of the government's fiscal health.*"

.091 They make it clear that they perceive that enhancing financial reporting depends not only on preparation of a consolidated report, but also reporting on a more comprehensive basis (Orme and Smith acknowledge that despite its shortfalls the prototype Consolidated Financial Statements (CFS) prepared by the US government are relevant — these statements include information about liabilities, some assets, revenues and expenses).

"*The prototype CFS is presently the only accessible source of information about the government's overall financial condition.*" (1985, page 17)

.092 Those prototype statements were first released in 1976. The statements proposed in respect of 1984 (US

Department of Treasury, 1985) included "on-budget" and "off-budget" agencies that are "clearly within the scope of government operations" and intergovernment transactions were eliminated. The Government Management Reform Act of 1994 requires annual federal government-wide financial statements starting with the fiscal year ending September 30, 1997 (although the method of combination has yet to be settled). These annual Statements are to be audited and submitted to the President and the Congress no later than the following March 31.

.093 In Canada, Public Sector Accounting Recommendations Section PS 1300 "*Financial Reporting Entity*" (CICA, 1996), advocates a broad concept of the financial reporting entity. It also advocates that, at each level of government, the government financial reporting entity should prepare consolidated financial statements except for government enterprises, which should be accounted for by the modified equity method (paragraphs .20 and .28)[1]. However, detailed information about the revenues, expenses, assets, liabilities and net assets of government enterprises are to be disclosed in notes (paragraph 36).

.094 The Comptroller-General of the United States of America and the Auditor-General of Canada recognize the importance of consolidated financial statements of the whole of government for legislators and management, as well as for a range of external users. They have prepared illustrative consolidated financial statements, on an accrual basis, for the Federal Government in each of these countries. (see GAO, Consolidated Financial Statements, 1984; and, Canadian Auditor-General and GAO, Federal Government Reporting Study, 1985.)

.095 However, it is interesting to note that in Canada, users studies as part of the joint exercise with the GAO, advocated a separation of commercial and non-commercial activities:

"most users studied in the US wanted all government activities consolidated regardless of the nature of the activities or the organizational form in which they are carried out. …

Many users in Canada believed that full consolidation is necessary to disclose fully the financial position and borrowing requirements of the government, to assess the socio-economic impact of government activities, and to assess the size and growth of government. Many others, however, saw a fundamental distinction between the commercial and non-commercial operations of government and wanted two separate consolidations … Most of these users wanted the government to account for its investment in government business enterprises on an equity basis." (Canadian Auditor-General and US GAO, Summary Report, 1986, pages 19-20)

.096 In relation to the joint exercise between Canada and the GAO, the approach adopted in the financial statements was to consolidate fully with, in respect of Canada:

(i) the financial statements separately identifying the assets, liabilities, revenues and expenses of government corporations; and

(ii) supplementary information being provided about individual corporations.

.097 In New Zealand, consolidated financial statements have also been prepared which reflect a broad view of the

[1] The only difference between the equity method and the "modified equity method" is that the latter allows business enterprises to account for their financial position and results using accounting principles generally accepted for profit-oriented enterprises. In all other respects, the application of the equity method is the same.

government as a financial reporting entity. The consolidated financial reporting entity comprises government Ministers, Departments and offices of Parliament reported on a line-by-line basis and net amounts reported on the basis of equity accounting for government business enterprises and other government entities. (1993, page 21) Consistent with the recommendations of the Finance and Expenditure Committee (Report, July 1991) the Reserve Bank is also fully consolidated because there are so many offsetting items.

.098 While differences may exist in respect of such matters as the basis of measurement of some asset categories, and the technique for merging some entities, financial statements prepared by the Australian States of New South Wales, South Australia, Victoria and Western Australia also reflect a broad concept of the government financial reporting entity and "consolidate" resources controlled by government. However, the treatment of financial institutions varies as between these State jurisdictions, with some excluding them and others consolidating them on a net equity basis.

.099 In determining whether financial statements of the entities that a government is responsible for should be consolidated, regulators will consider such factors as whether consolidated financial statements are:

(i) a more effective means of communicating financial information to a wide range of users; given that an appropriate balance between detail and overview is established; and

(ii) overcome concerns that users of fund based reports will fail to identify and adjust for any inter-fund transfers and transactions and will, therefore, develop an erroneous view of, for example, the assets, liabilities, costs of operations and the financial results of the activities conducted by the entity.

.100 Even where the consolidated approach is supported, the techniques adopted for consolidating controlled entities, particularly in respect of those entities not considered part of "core" government, or those entities which operate on a commercial basis, can differ. In selecting accounting approaches, policy makers will consider whether different consolidation techniques should be adopted for different types of controlled entities. Different treatments may be adopted to convey clear messages to users that, encompassed within the financial report, are entities which operate in different sectors and for which the extent of control and funding by government is different.

.101 Figure 3.1 identifies the basis of combination recommended by accounting bodies and/or governments in a number of jurisdictions.

.102 It is apparent from the information shown in Figure 3.1 that the equity method is sometimes adopted to recognize in a government's financial report the financial effects of activities that are not considered to be "core" government activities. These are often activities carried out by government business enterprises. New Zealand government enterprises are considered to be part of the government financial reporting entity but they are included using the equity method. Reasons advanced for combining these enterprises using the equity method include the possibility that some of the entities may be sold in the future, a desire to more appropriately reflect the enterprises' arm's-length relationship with the Crown and a reflection that the Crown has legislated to exclude itself from responsibility for these enterprises' liabilities.

.103 The use of the equity method may also be consistent with a government's financial report prepared on a modified accrual basis of accounting, under which only financial assets and liabilities are recognized. That is, the equity basis can be a basis of measuring a financial interest (asset) in a business enterprise. However, it should be noted that consolidation can also be consistent with a modified accrual basis of accounting.

.104 The method of combination chosen may also be influenced by the costs and practicalities of eliminating inter-entity transactions.

Other Disclosures

.105 While financial reports can be produced for government as a whole, they may not provide adequate information for users to evaluate the performance of government departments, agencies or programs.

.106 Therefore, if a broad concept of the government financial reporting entity is adopted, regulators, standard-setters and those responsible for the implementation of standards may need to ensure that there is adequate disclosure of "segment" information about the budget sector (and/or sections thereof) and/or broad programs.

For example, segment disclosures relating to all schools or all hospitals may be useful in assessing the financial management of government education and health programs.

.107 Whether or not subsidiary entities should also be considered to be separate reporting entities will depend on the existence of users dependent on financial reports for information for accountability and economic decision-making purposes, or the existence of legislation or regulation which requires them to report separately.

.108 It may also be useful for a government financial report to disclose information about entities that are substantially dependent on government funding but which are not included in the government financial reporting entity. This could include the nature of relationships between a government and such entities and an explanation as to why they are not part of the government financial reporting entity. This information would be useful in explaining the boundaries of the government financial reporting entity.

Reporting Entities Comprising the Government Financial Reporting Entity

.109 Orme and Smith identify the necessary components for a Consolidated Financial Statement (CFS):

"*There are three basic mandates for developing a CFS. First, the CFS should be comprehensive — that means the financial statement, as well as all supporting data, must include all significant transactions and entities. Second, all the entities in the consolidation must have common financial accounting systems. Last, the financial transactions should be recorded using a common set of accounting principles which are consistently applied and interpreted by each reporting entity.*" (Orme and Smith, 1985, page 17)

.110 In many jurisdictions, most government business enterprises, whether they are constituted as statutory authorities or corporations, now report on an accruals basis. PSC Guideline 1 recommends that government business enterprises adopt International Accounting Standards, and a form of modified or full accrual accounting is adopted in some jurisdictions by governments and their entities, for example, in New Zealand and the Australian state of New South Wales. The Australian Federal Government and the governments of a number of the other Australian states have indicated their intention to implement accrual accounting. The Federal Government of the United States of America also supports the use of accrual accounting.

.111 All entities forming part of the government financial reporting entity may not adopt the same basis of accounting for preparation of their individual financial statements. In such cases, a consistent message can only be presented by reporting on the narrowest of the bases adopted by the entities. Given that different bases are frequently adopted by the budget sector and non-budget sector, separate consolidations for these sectors may be necessary.

Figure 3.1

CRITERIA FOR AND BASIS OF COMBINATION

GOVERNMENT OR ACCOUNTING PROFESSION AUTHORITATIVE PRONOUNCEMENTS

COUNTRY	DOCUMENT	BASIS OF COMBINATION
Australia	(a) General professional requirement Australian Accounting Standard AAS 24 "Consolidated Financial Reports" (1992); and ED 62 "Financial Reporting by Governments" (b) New South Wales Public Finance and Audit Act 1983	Control [capacity to dominate decision-making in relation to financial and operating policies to achieve common objectives] (paragraph 18, AAS 24) Line-by-line consolidation required where there is control. Control [as above]. Line-by-line consolidation for entities providing social services via departments and statutory bodies which enjoy various degrees of monopolistic protection given by the State. Equity method of accounting for state-owned financial institutions.
Canada	Public Sector Accounting Recommendations, Section 1300 "Financial Reporting Entity" (1996)	Line-by-line consolidation for organisations integral to the overall operations of government in directly performing its executive function such as government departments, special funds and government organisations that exist primarily to provide services to governments (paragraphs .19 and .20). Modified equity method of accounting for government business enterprises (paragraphs .21 and .28). Government business enterprises are defined as an organization that has all of the following characteristics: • it is a separate legal entity with the power to contract in its own name and that can sue and be sued; • it has been delegated he financial and operational authority to carry on a business; • it sells goods and services to individuals and organisations outside of the government reporting entity as its principal activity; and • it can, in the normal course of its operations, maintain its operations and meet its liabilities from revenues received from sources outside of the government reporting entity (paragraph .21).
Italy	National Law no. 362 of August 1988	Financial statements of entities for which government is responsible are annexed to the government's financial statements.
Netherlands	National government — Accountability Law	Budget dependency. Line-by-line consolidation as far as the State Balance is

COUNTRY	DOCUMENT	BASIS OF COMBINATION
	(“Comptabiliteitswet”)	concerned and simply combining as far as the Central Government accounts are concerned. Financial information about the results of agencies are specified in the departmental accounts. Information about the governmental participation in limited companies is given in the notes to the State Balance.
New Zealand	Public Finance Act 1989	Ownership, determined with reference to “control”. Line-by-line consolidation for departments and offices of Parliament, the Reserve Bank which are part of the Crown legal entity. Equity method of accounting for separate entities in which the Crown owns a majority of the voting shares; or has the power to dismiss a majority of the governing body which is primarily accountable to the Crown; or the Crown has a right to more than half of the net assets on disestablishment; or where the Crown would assume any residual liabilities.
Portugal	Constitution of the Portuguese Republic and State Appropriation Acts	Budget dependency. Budget dependent activities/entities, including “autonomous bodies” that have their own assets/revenues, are combined. The Bank of Portugal (central bank) reports separately.
Taiwan	Budget Law Law of Accounting Annual Reporting Law	Ownership/budget dependency. Line-by-line consolidation of all government funds in a statement of revenues and expenditures, with the net results from government business undertakings recognised as a revenue or expenditure. A supplementary schedule displays a line-by-line consolidation of all government assets and liabilities, including all those of government business undertakings.
United States of America	(a) Federal Statement of Federal Financial Accounting Concepts “Entity and Display” (1995)	 Budget dependency/ownership. Consolidation of departments, independent agencies and government corporations with consideration given to also reporting separate information on significant components in a consolidated report, separate reports, or accompanying footnotes. The Federal Reserve system is excluded.
	(b) State and Local Statement No. 14 of GASB “The Financial Reporting Entity” (1991)	 Primary government reports separately using fund accounting. Legally separate component units for which the primary government has financial accountability are discretely presented in the statements. No consolidations.

CHAPTER 4

SUMMARY

.112 Governments are reporting entities that should prepare general purpose financial reports. Governments control significant resources and a potentially wide range of users are dependent on their financial reports for financial information for accountability purposes and as an input for making decisions about the allocation of resources.

.113 The nature of the entities, transactions and events that should be encompassed by the financial report of the government should be determined by reference to the objective of financial reporting, which PSC Study 1 identifies as the provision of information for accountability and decision making purposes.

.114 There are at least two distinct views about how to determine the boundaries of the government financial reporting entity in order to best satisfy the objective. One recommends reporting on the basis of the authorised allocation of public funds. An alternative view suggests reporting on the basis of all the resources for which the government is responsible, using control or ownership as a criterion.

.115 In this Study, it is argued that governments should be accountable for the resources that they control and, accordingly, the boundaries of the government financial reporting entity should be widely drawn to encompass all resources that the government controls. Any other basis for determining the boundaries of the government financial reporting entity would not meet the objective of the provision of information for accountability and decision making purposes.

.116 In addition, while the boundaries of the government financial reporting entity may be drawn widely, the financial report should disclose information about the major components or segments of the government. That disclosure may be effected by preparation of summary financial statements for the government as a whole supported by note disclosure of major programs or sectors of government operations.

.117 However, agreement that governments are reporting entities and that their boundaries should be widely drawn will not resolve issues about matters such as:

(i) the content of the government financial report;

(ii) the reporting format that should be adopted to communicate financial information;

(iii) whether consolidated financial reports should be prepared for all of the entities and transactions encompassed in the government financial reporting entity;

(iv) the consolidation technique to be adopted; and

(v) the additional segment and other information to be disclosed to ensure that relevant messages about the "components" of government are reported to users.

.118 Resolution of these issues is dependent on assessments of such matters as:

(i) users' information needs and the extent to which financial reports can, and should, satisfy those needs; and

(ii) the accounting basis that is likely to be most effective in communicating clear messages about the government's accountability for the resources it controls and the obligations for which it is responsible.

APPENDIX 1

Objectives Of Financial Reporting

Financial reporting should demonstrate the accountability of government or (government) unit for the financial affairs and resources entrusted to it, and provide information useful for decision-making by:

a. Indicating whether resources were obtained and used in accordance with the legally adopted budget.

b. Indicating whether resources were obtained and utilised in accordance with legal and contractual requirements, including financial limits established by appropriate legislative authorities.

c. Providing information about the sources, allocation and uses of financial resources.

d. Providing information about how the government or unit financed its activities and met its cash requirements.

e. Providing information that is useful in evaluating the government's or unit's ability to finance its activities and to meet its liabilities and commitments.

f. Providing information about the financial condition of the government or unit and changes in it.

g. Providing aggregate information useful in evaluating the government's or unit's performance in terms of its service costs, efficiency and accomplishments.

(Source: PSC Study 1, Financial Reporting by National Governments, IFAC, 1991, page 11)

APPENDIX 2

Glossary Of Terms

Basis of Accounting: refers to the body of accounting principles that determine *when* the effects of transactions or events should be recognised for financial reporting purposes. It relates to the timing of the measurements made, regardless of the nature of the measurement. Common bases of accounting are the cash basis of accounting (i.e., effects of transactions or events are recognised when cash is paid or received) and the accrual basis of accounting (i.e., effects of transactions and events are recognised when they take place). There are many variations of both bases.

Elements of Financial Statements: refers to the types or classes of items that are reported in the financial statements, including notes thereto and related schedules. That is, the classes of items around which the financial statements are constructed.

Financial Reporting: refers to the communication of financial information by an entity to interested parties. It encompasses all reports that contain financial information based on data generally found in the financial accounting and reporting system. It includes financial statements as well as financial information presented in budgets, fiscal plans and estimates of expenditure or reports on the performance of individual programs or activities.

Financial Reports: refers to the general purpose financial reports that are designed to meet the common information needs of users outside of the entity. Those external users rely on the reports as an important source of financial information because they have limited authority, ability, or resources to obtain additional information. While financial statements comprise the core of the financial reports, other financial information, such as performance measures and budget information, might also be included.

Financial Statements: refers to the accounting statements prepared by a reporting entity to communicate information about its financial performance and position. They include those notes and schedules that are needed to clarify or further explain items in the statements. For business-oriented enterprises, financial statements normally include a balance sheet, income statement, statement of retained earnings and statement of cash flows. Governments and government units may have a similar set of statements or may have lists of assets and liabilities, revenues and expenditures.

Measurement Focus: refers to *what* messages and information are portrayed in the financial statements. A particular measurement focus is accomplished by considering not only when the effects of transactions and events involving those resources are recognised (i.e., the basis of accounting), but also what resources are measured. For example, the financial statements of business enterprises are designed to measure profit or loss and changes in shareholders' equity. Government financial statements could be designed to express, for example, the flow of economic resources, the flow of total financial resources or the flow of current financial resources.

Reporting Model: refers to the configuration and presentation of financial statements, in particular, what statements are included in the set of financial statements, how they interrelate, and how key measures are displayed in them.

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