CHAPTER 11

THE GOVERNMENT OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION

GOVERNMENT SECRETARIAT

Finance Bureau

Review of the financial reporting of the Government

Audit Commission
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REVIEW OF THE
FINANCIAL REPORTING OF THE GOVERNMENT

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Summary and key findings

A. **Introduction.** In order to comply with the statutory financial reporting requirements (essentially contained in the Audit Ordinance), the Director of Accounting Services compiles annual financial statements of the Government's General Revenue Account and Funds established under the Public Finance Ordinance. These financial statements are prepared on the conventional cash basis which recognises transactions only at the time when cash is received or paid (paras. 1.1 and 2.3).

B. **Audit review.** In view of the development of improved governmental financial reporting in developed countries, and the increasing public demand for public accountability for the use of government resources, Audit recently conducted a review on the financial reporting framework of the Government (para. 1.3).

C. **Views of international organisations.** The Organisation for Economic Cooperation and Development (OECD) considers that, in relation to governmental financial reporting, cash accounting can provide information useful for assessing short-term economic impact and compliance with spending limits. However, the OECD has observed that cash accounting has some limitations: it does not provide a proper basis for judgement on performance in terms of economy, efficiency, and achievement of objectives. The International Federation of Accountants has expressed similar views on the inadequacies of cash-based accounts for governmental financial reporting (paras. 3.1 to 3.9).

D. **Audit's assessment of the Government's financial reporting.** Audit notes that the Government's cash-based financial reporting cannot reflect the total resources consumed by departments, show the use of physical assets or record future liabilities. Such information is essential for effective resource management, decision-making and judging the Government's performance. Audit considers that the Government's cash-based financial reporting is inadequate to meet the present-day needs of users (paras. 3.10 and 3.11).

E. **International developments.** Since the last decade, a number of developed countries have made significant progress in adopting accrual accounting, which recognises transactions at the time when they occur, in their public sector financial reporting. These countries include Australia, Canada, Finland, Iceland, New Zealand, Sweden, the United Kingdom and the United States. The OECD has observed that the total benefits to all users that are expected to arise from the accrual basis of accounting should exceed the costs of doing so (paras. 1.2, 4.3 and 4.6).

F. **Benefits of accrual accounting.** One major benefit of accrual accounting for governmental financial reporting is that it facilitates decision-making. The provision of full cost information helps enhance resource allocation and contracting out decisions, and assess the efficiency of government services. The provision of information on assets and liabilities also helps improve asset utilisation and working capital management. Furthermore, disclosure of information on full cost and on government assets and liabilities is essential for achieving public accountability, which enables the public to assess the cost effectiveness of government services and the performance of government departments (paras. 5.2 to 5.5).

G. **The Government's efforts in implementing accrual accounting.** In 1993, a Working Group was set up to review the financial reporting of the Government. In 1994, the Government endorsed the Working Group's recommendation for the Government to produce accrual-based departmental resource accounts (DRAs). In the same year, the Government commissioned a consultancy study on the implementation of DRAs. The consultants recommended that all government departments should prepare DRAs annually. In late 1994, a pilot study on DRAs was conducted in four departments. This was followed in 1996 by an extended pilot study in another six departments. The responses from the ten departments and their policy bureaux were mixed. Audit notes that the reasons given for not supporting DRAs were of doubtful validity. However, such arguments were not critically assessed by the Finance Bureau and were not refuted. Audit also notes that in assessing the pilot studies, due consideration was not given to the usefulness of DRAs from the perspective of public accountability. In April 1999, a Task Force chaired by the Secretary for the Treasury was set up to review the Government's financial reporting policy. The Task Force will report to the Financial Secretary by the end of calendar year 2000 the standards and style of financial reporting for the Government (paras. 6.2 to 6.16, 7.13 and 7.14).

H. **Audit recommendations.** Audit has recommended that, in the Task Force's current review of the Government's financial reporting, the Secretary for the Treasury should:

— fully take into account the inadequacies of the cash-based financial reporting of the Government and the benefits of accrual accounting (para. 7.2);

— expedite action on deciding whether or not to adopt accrual accounting in the Government and, if in the affirmative, draw up a definite timetable of implementation (para. 7.2);

— in assessing the various options of financial reporting, consider whether it is feasible for departments to absorb the implementation costs through productivity enhancement, and whether a phased implementation should be adopted (para. 7.6);

— draw up clear procedures for critically assessing feedback from the parties concerned (para. 7.15); and

— apart from the use of DRAs as an internal management tool, give due consideration to the need for enhancing external performance reporting and public accountability (para. 7.15).

I. **Response from the Administration.** The Secretary for the Treasury has said that this audit report provides timely and valuable input which will be fully taken into account in the Task Force's deliberations (para. 8.1).

PART 1: INTRODUCTION

Background

1.1 In 1998-99, the Government raised $208 billion in revenue, and spent $164 billion in recurrent expenditure and $75 billion in capital expenditure. To account for these income and expenditure, the Director of Accounting Services, who acts as the accountant of the Government, compiles a set of annual financial statements for the Government. These financial statements are prepared on the conventional cash basis which recognises transactions only at the time when cash is received or paid. These financial statements are audited by the Director of Audit. The audited financial statements, together with the Director of Audit's Report, are tabled in the Legislative Council (LegCo), in accordance with the Audit Ordinance (Cap. 122).

1.2 In the past decade, major developed countries around the world began changing their financial reporting from the conventional cash basis to an accrual basis which recognises transactions at the time when they occur. These countries include Australia, Canada, Finland, Iceland, New Zealand, Sweden, the United Kingdom, and the United States. The main reasons for the change were to provide fuller information to the management to help improve decision-making with a view to providing efficient and effective public services, and to provide better public accountability for the use of public resources. In Hong Kong, also in pursuit of improved management of the civil service and better public accountability, Members of LegCo have raised questions on whether there was a need to change the basis of accounting adopted by the Government. In response, the Government has reviewed its financial reporting system and conducted pilot studies on the implementation of accrual accounting in the Government.

Audit review

1.3 In view of the development of improved governmental financial reporting in developed countries, and the increasing public demand for greater public accountability for the use of government resources, Audit recently conducted a review on the financial reporting framework of the Government.

Audit objectives

1.4 The objectives of the review were to:

— assess the adequacy of the cash-based financial reporting of the Government and, in the light of overseas experience, ascertain the benefits of adopting accrual accounting in the Government; and

— take stock of the Government's efforts in implementing accrual accounting in the Government.

PART 2: STATUTORY FRAMEWORK AND ARRANGEMENTS FOR FINANCIAL REPORTING

Statutory framework

2.1 The statutory framework governing financial reporting in the Government is essentially contained in the Audit Ordinance.

2.2 Section 11 of the Audit Ordinance states that the Director of Accounting Services shall, within the period of five months or such longer period as the Chief Executive may determine, after the close of each financial year, submit to the Director of Audit:

— a statement of the assets and liabilities and a statement of the receipts and payments for the Government;

— a statement of the assets and liabilities and a statement of the receipts and payments for each Fund established in accordance with section 29 of the Public Finance Ordinance (PFO) (Cap. 2) (Note 1); and

— such other statements as the Chief Executive may specify from time to time.

Annual financial statements compiled by the Director of Accounting Services

2.3 In order to comply with the statutory requirements as stated in paragraph 2.2 above, the Director of Accounting Services compiles annual financial statements of the Government's General Revenue Account (GRA) (Note 2) and the eight Funds established under the PFO (see Note 1). These financial statements, which are prepared on a cash basis, include statements of assets and liabilities, and statements of receipts and payments.

Note 1: *Eight Funds have been established in accordance with section 29 of the PFO. These are: Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Land Fund, Loan Fund, and Lotteries Fund. For the first seven Funds, the financial reporting requirements are laid down in the Audit Ordinance. For the Lotteries Fund, the requirements are laid down in the Government Lotteries Ordinance (Cap. 334). The purposes of these eight Funds are shown in Appendix A.*

Note 2: *For control and funding purposes, the Government's financial activities are undertaken through a variety of accounts and funds. The GRA acts as the central funding device with resources being transferred as necessary to funds established to finance specific activities.*

Other annual financial statements prepared by government departments and government utilities

2.4 In addition to the annual financial statements compiled by the Director of Accounting Services, some government departments and government utilities also compile their annual accounts, as follows:

— ***Trading Fund accounts.*** Accounts for Trading Funds (Note 3) are prepared on an accrual basis. These accounts are similar to the accounts compiled by companies incorporated under the Companies Ordinance (Cap. 32). Trading Fund Accounts are audited by the Director of Audit and are tabled in LegCo. At present, there are five Trading Funds in operation, i.e. those for the Companies Registry, Electrical and Mechanical Services, Land Registry, Office of the Telecommunications Authority and Post Office; and

— ***Operating accounts of government utilities.*** Government utilities (e.g. the Water Authority and government toll-tunnels) produce operating accounts. These operating accounts are also compiled on an accrual basis.

Note 3: *A Trading Fund is a financial and accounting arrangement which enables a department to operate on a commercial basis, while remaining as part of the Government. The objective is to improve the quality of service to customers.*

PART 3: ASSESSMENT OF THE ADEQUACY OF THE CASH-BASED FINANCIAL REPORTING OF THE GOVERNMENT

Objectives of governmental financial reporting

3.1 According to a study conducted by the Organisation for Economic Cooperation and Development (OECD) (Note 4) in 1993, work undertaken to define the objectives of accounting and financial reporting in the public sector has suggested a range of information needs which governments have to address. In order to meet these needs, various types of information are required to be provided to users of financial statements of governments and public enterprises. These include information on compliance and stewardship, the state of finances, performance and economic impact as shown in Table 1 below.

Table 1

Types and uses of information

Type of information	**Use of information**
Compliance and stewardship	This enables users to assess whether resources are obtained/used in accordance with legal/contractual requirements, and to ascertain whether proper stewardship has been exercised over the custody of financial/physical resources.
State of finances	This facilitates users to assess the sources/types of revenues, allocation/use of resources, extent to which revenues sufficiently cover costs of operations (including non-cash cost), timing/volume of cash flows, ability to meet financial obligations (both short and long term) and overall financial condition.
Performance	This helps users assess the economy and efficiency of operations, and ascertain whether previously announced goals and objectives have been met.
Economic impact	This helps users assess the economic impact of government activities on the economy, and assess government spending options and priorities.

Source: The OECD

Note 4: *The OECD was formed in 1961. Its main objectives are to build strong economies in its member countries, improve efficiency, expand free trade and contribute to the development in industrialised as well as developing countries. The OECD has 29 member countries, a full list of which is at Appendix B.*

Views of the OECD on cash accounting

3.2 The OECD is of the view that cash accounting cannot meet all of the above information needs. Cash accounting has certain benefits in terms of assessing short-term economic impact and compliance with spending limits. However, its ability to help decision-making on stewardship and the state of finances is limited. Furthermore, cash accounting does not provide a proper basis for judgement on performance in terms of economy and efficiency, or on the achievement of goals or objectives.

Views of the International Federation of Accountants on cash accounting

3.3 The views of the International Federation of Accountants (IFAC) (Note 5) on cash accounting, as expressed in an Exposure Draft "Guideline for Governmental Financial Reporting" issued in 1998, are described in paragraphs 3.4 to 3.9 below.

Benefits of cash accounting

3.4 ***Demonstrating compliance with appropriations.*** To the extent that budgets and other requirements are themselves cash based, cash-based accounts are able to demonstrate compliance with legally adopted budgets and with legal and contractual requirements.

3.5 ***Favourable qualitative characteristics.*** The principles underlying the cash basis are easy to understand and easy to explain. To the extent that cash flows are uniform over time, cash-based accounts may have high levels of reliability and comparability. Because it is relatively easy to compile cash-based information, reports may be more timely than under other bases of accounting.

3.6 ***Costs.*** Extensive accounting skills are not required to operate cash-based accounting systems or to prepare cash-based financial statements. Governments using the cash basis of accounting have therefore required fewer trained staff than those using other bases. The cost of providing cash information is lower than that under alternative bases.

Limitations of cash accounting

3.7 ***Inability to provide more complex information.*** Increasingly, users of governmental financial statements are expecting information on assets and liabilities, and the impact of current consumption of the stock of net assets held by a government. However, cash accounting is not designed to meet these information needs. Therefore, those who have more extensive information

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Note 5: *IFAC is an organisation of national professional accountancy organisations that represent accountants employed in different sectors. Currently, it has 143 member bodies in 104 countries including the People's Republic of China. IFAC's main objective is to develop the profession and harmonise its standards on a world-wide basis to enable accountants to provide services of consistently high quality in the public interest.*

requirements need to maintain supplementary records, or consider moving to a different basis of accounting.

3.8 ***Failure to show non-cash resource flows.*** Cash accounting focuses solely on cash flows and ignores other resource flows which may also impact upon the ability of a government to provide goods and services now, and in the future. For this reason cash-based information may be less relevant to decision-makers. Moreover, cash accounting limits the ability of the electorate to hold a government accountable for the use of all of its resources due to the lack of information on assets and liabilities.

3.9 ***Complexity of cash-based accounts.*** Despite the apparent simplicity of cash accounting, in practice, financial statements prepared under a cash basis may be complex and may not be easy for users to understand. This is largely due to the practice of reporting receipts and payments in great detail.

Audit's assessment of the adequacy of the Government's financial reporting

3.10 Under the PFO, the payments which are permitted to be made by the Government in a financial year are limited to the funds voted by LegCo. In approving the expenditure estimates, LegCo also approves in some detail the purposes for which those payments can be made. By showing that spending has been made on the services and within the limits approved by LegCo, the Government's cash-based accounts achieve the objective of demonstrating the Government's compliance with the appropriations (see Table 1 in paragraph 3.1, and paragraph 3.4 above).

3.11 However, cash accounting focuses on cash flows and ignores other resource flows. As a result, the Government's cash-based financial reporting cannot reflect the total resources consumed by departments. It also cannot show the use of physical assets or record future liabilities. As pointed out by the OECD and IFAC, such information is essential for effective resource management, decision-making and judging the Government's performance (see paragraphs 3.2 and 3.8 above). **In this regard, Audit considers that the Government's cash-based financial reporting is inadequate to meet the present-day needs of users.**

PART 4: INTERNATIONAL DEVELOPMENTS IN PUBLIC FINANCIAL REPORTING

Growing recognition of the need for accrual accounting

4.1 There is growing recognition among developed countries that public sector entities should be accountable to their stakeholders for more than just cash flows and cash balances. As a result, many developed countries have introduced public management reforms which emphasise the cost effectiveness of activities. These reforms incorporate a range of incentives to encourage better management and provide greater flexibility in the allocation of resources. The successful implementation of these reforms requires financial reporting which encompasses the allocation and use of total economic resources, both cash and non-cash, at the disposal of managers. These give rise to the need for accrual accounting in the public sector.

The OECD's 1993 study

4.2 The study conducted by the OECD in 1993 (see paragraph 3.1 above) produced a paper on the experience of five OECD countries which had introduced or were introducing some form of accrual accounting into their public sectors. The five countries were Australia, Iceland, New Zealand, the United Kingdom and the United States.

4.3 Based on the experience of these countries, the OECD observed that the full assessment of costs and benefits of accrual accounting must await experience with implementation. Due to the incremental introduction of public sector reforms in recent years which required more comprehensive financial information, the costs associated with the introduction of accrual accounting had in many instances been mixed with the costs of the other public sector reforms. **The OECD study, however, concluded that "clearly the total benefits to all users that are expected to arise from providing information should exceed the costs of providing it".**

4.4 In addition to the five countries mentioned in paragraph 4.2 above, Audit notes that Canada, Finland and Sweden have also made significant progress in adopting accrual accounting in their public sector financial reporting. The developments in the adoption of accrual accounting in these eight countries are described in paragraphs 4.5 and 4.6 below.

Developments in the adoption of accrual accounting in developed countries

4.5 Based on the experience of the eight countries, Audit notes that the migration from cash accounting to accrual accounting normally undergoes three stages of development, as follows:

- Stage One: adoption of the accrual basis for the accounts of individual agencies and government departments;

- Stage Two: adoption of the accrual basis for the whole-of-government accounts; and

- Stage Three: adoption of the accrual basis for budgetary controls.

4.6 Table 2 below shows the developments in adopting accrual accounting in the eight countries.

Table 2

Developments in adopting accrual accounting in eight developed countries

Country	**Stage One: Accrual basis for accounts of agencies and departments**	**Stage Two: Accrual basis for whole-of-government accounts**	**Stage Three: Accrual basis for budgets**
Australia	Since 1994-95	Since 1996-97	Since 1999-2000
Canada	Adopted modified accrual accounting (Note 1) since 1980's. Will adopt full accrual basis from 2001-2002	Adopted modified accrual accounting since 1980's. Will adopt full accrual basis from 2001-2002	Not yet announced
Finland	Since 1998	Since 1998	Not yet announced
Iceland	Adopted modified accrual accounting since 1992	Adopted modified accrual accounting since 1992	Since 1998, Iceland has prepared budgets on both cash basis and modified accrual basis.
New Zealand	Since 1992-93	Since 1992-93	Since 1994-95
Sweden	Since 1994	Since 1994	Not yet announced
United Kingdom	Since 1998, all departments have prepared departmental resource accounts (DRAs) (Note 2) to supplement the cash-based appropriation accounts.	Will adopt accrual basis from 2003-2004	Will prepare accrual-based budgets (for DRAs) from 2001-2002
United States	Since 1997-98	Since 1997-98	Budgets are prepared on a cash basis while credit programmes are on an accrual basis.

Source: Audit's research

Note 1: Modified accrual accounting is essentially full accrual accounting, except that the costs of capital assets are fully charged to the accounts at the time of purchase.

Note 2: DRAs bring together the inputs, on an accrual basis, with their relevant outputs. The full costs of resources (i.e. not only cash costs) consumed include staff costs, operating expenses, disbursements, accommodation, depreciation and services from other departments.

PART 5: BENEFITS OF ADOPTING ACCRUAL ACCOUNTING IN GOVERNMENTAL FINANCIAL REPORTING

5.1 According to the OECD, the primary aims of any accounting and reporting system should be to provide information useful to facilitate decision-making as well as to best meet the need for accountability for resources.

Accrual accounting facilitates decision-making

5.2 In relation to the objective of facilitating decision-making, the benefits of accrual accounting, as identified by the OECD's study in 1993 (see paragraph 4.2 above), include the following:

(a) provision of information on full cost of running departments, agencies and their programmes, which helps enhance resource allocation decisions;

(b) provision of full cost information to facilitate decisions on contracting out, market testing of public sector services, and establishing internal and external charging;

(c) provision of information on full input costs in relation to outputs, which provides a mechanism for measuring the level of efficiency of programmes and activities and assessing changes in it over time;

(d) facilitating better management of assets by making the values of underutilised assets visible;

(e) provision of details on accounts payable and receivable and inventories, thus enhancing cash management and minimising working capital requirements; and

(f) facilitating benchmark comparisons between similar entities within the public sector and between similar public and private sector activities to assess the entities' performance.

Accrual accounting enhances public accountability

5.3 As defined by the Asian Organisation of Supreme Audit Institutions (ASOSAI) (Note 6) in the Tokyo Declaration of Guidelines on Public Accountability in 1985, public accountability means "the obligations of persons/authorities entrusted with public resources to report on the

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Note 6: *ASOSAI is one of the Regional Working Groups of the International Organisation of Supreme Audit Institutions (INTOSAI). INTOSAI was founded in 1953. It provides a network for the international public sector audit community. It also promotes the exchange of audit and financial management information and experience among member nations. Its current membership includes the national audit offices of more than 150 member nations of the United Nations Organisation.*

management of such resources and be answerable for the fiscal, managerial and programme responsibilities that are conferred”.

5.4 To achieve public accountability, the following elements are essential in governmental financial reporting:

— disclosure of information on the full cost of resources used in the delivery of government services enables the public to assess the cost effectiveness of these services and the performance of government departments; and

— disclosure of information on government assets and liabilities facilitates public monitoring of the use of these assets, and helps investors and traders assess the net worth of a government.

Benefits of accrual accounting as identified by IFAC

5.5 In 1998, in the Exposure Draft “Guideline for Governmental Financial Reporting” (see paragraph 3.3 above), the IFAC identified benefits similar to those mentioned in paragraphs 5.2 to 5.4 above for the adoption of accrual accounting by governments. In particular, the Exposure Draft states that accrual accounting provides users with information which:

— allows them to evaluate a government’s ability to finance its activities and to meet its liabilities and commitments;

— shows a government’s financial position and changes therein; and

— is useful in evaluating a government’s performance in terms of its service costs, efficiency and accomplishments.

PART 6: THE GOVERNMENT'S EFFORTS IN IMPLEMENTING ACCRUAL ACCOUNTING

Accrual accounting implemented for Trading Funds and government utilities

6.1 As mentioned in paragraph 2.4 above, the Government has implemented accrual accounting for Trading Funds and government utilities where the commercial nature of such operations makes this appropriate. However, for the Government's core accounts which are still prepared on a cash basis (i.e. those mentioned in paragraph 2.3 above), the Government has been conducting reviews on the use of accrual accounting. These are described in paragraphs 6.2 to 6.16 below.

1993 Working Group on financial reporting

6.2 In June 1993, the Standing Committee on Financial Management (SCFM), chaired by the Secretary for the Treasury, endorsed the setting up of a Working Group to review the financial reporting of the Government. The main terms of reference of the Working Group were to propose a financial reporting framework and quantify the costs and benefits associated with its implementation. The Working Group was chaired by the Deputy Director of Accounting Services, with members from the Treasury, the Finance Bureau, the academic field and the Hong Kong Society of Accountants.

6.3 In March 1994, the Working Group concluded that the existing financial reporting arrangements, although capable of demonstrating the stewardship responsibility, fell short of providing adequate information for resource management, decision-making and accounting for value for money. The Working Group recommended that:

— due to the need to demonstrate the stewardship accountability required under the appropriation system, the existing published accounts should continue to be prepared;

— to complement the cash-based accounts, it would be both desirable and practicable for the Government to produce accrual-based accounts, i.e. DRAs;

— a pilot study on DRAs should initially be undertaken by a number of departments; and

— in the longer term, DRAs should be published as part of government accounts.

6.4 In June 1994, the SCFM endorsed in principle the Working Group's recommendations.

1994 consultancy study

6.5 In October 1994, in parallel with the conduct of a pilot study on DRAs (see paragraph 6.9 below), the Government commissioned a consultancy study on the implementation of DRAs in the Government.

6.6 In January 1995, the consultants recommended that the Government should introduce DRAs and present accrual-based and full cost financial reports annually to complement its cash-based accounts. The consultants also recommended that:

— all government departments should prepare DRAs annually; and

— DRAs should be subject to compliance audit.

6.7 The consultants identified the following benefits which would be obtained from the introduction of DRAs:

(a) improving external performance reporting and public accountability;

(b) bettering public policy development by focusing on high priority programmes;

(c) facilitating performance measurement;

(d) assisting in decisions on changing the resource mix;

(e) enhancing financial management practices, such as investment in inventories; and

(f) complementing and enhancing the efficiency initiatives which were being undertaken by the Government.

6.8 The consultants recommended that DRAs should be implemented in two phases over a period of 30 months. Each phase would involve about 40 departments. The consultants estimated that for implementing DRAs it would cost $51 million in the first year, with an annual recurrent cost of $27 million in subsequent years. **The consultants considered that the implementation costs were not significant when compared with the Government's annual expenditure, and that a very small saving in the Government's expenditure would justify the cost of adopting DRAs.**

1994 pilot study on DRAs

6.9 In late 1994, in response to the Working Group's recommendations, the Treasury conducted a pilot study, involving four departments, namely the Architectural Services Department (ASD), Fire Services Department (FSD), Social Welfare Department (SWD) and Treasury. The main objective of the study was to ascertain the feasibility and implications of introducing DRAs at the departmental level. The four departments involved in the pilot study produced DRAs for 1993-94.

6.10 In early 1995, the Director of Accounting Services invited comments from the ASD, the FSD and the SWD on whether DRAs would produce the benefits envisaged by the consultants (see paragraph 6.7 above). In mid-1995, the Secretary for the Treasury invited the policy bureaux of the three departments involved to give comments on how policy secretaries could make use of DRAs to improve their decision-making process and resource prioritisation. Furthermore, in late 1995, Treasury also gave comments on DRAs in a paper prepared for the SCFM. The responses from the departments and their policy bureaux were mixed, which are summarised in Table 3 below.

Table 3

Responses from the four departments involved in the 1994 DRA pilot study and from their policy bureaux

	Department/ Bureau	Responses
(a)	ASD	The benefits of DRAs may have been overstated as they are based on the implementation of accrual accounting but with no overall consolidated account being prepared. This dilutes the ASD's contribution to programme areas under the present format. Much more work needs to be done in this area in order to reflect the proper worth of the ASD.
(b)	FSD	DRAs will complement the existing cash-based financial reporting. However, the benefits of DRAs can only be realised if: the accounts and future cost projections can be prepared in time for the annual Resource Allocation Exercise; and FSD is given the authority to determine the utilisation of its resources. Furthermore, FSD's activities vis-à-vis their full costs do not readily lend themselves to the derivation of any meaningful cost efficiency measures.
(c)	SWD	SWD supports the DRA concept and expects that the benefits would materialise. SWD will prepare an outline action programme for further developing and implementing DRAs in the Department. SWD believes that DRAs should be subject to compliance audit.

Table 3 (Cont'd)

(d)	Treasury	DRAs make it possible to have a picture of the consolidated position of the Treasury. This will assist in planning at the macro as opposed to the micro level.
(e)	Works Bureau (as ASD's policy bureau)	As long as the current budgetary process remains unchanged, DRAs will only have a supplementary role to play. While DRAs may have the potential of becoming a tool to assist departments in making decisions on deployment of their resources more effectively, it will have limited application to the Works Bureau as very often very costly services of departments/agencies cannot be replaced by cheaper ones offered by other suppliers because of the differences in discipline/expertise.
(f)	Health and Welfare Bureau (as SWD's policy bureau)	The DRA concept is laudable which will improve the external performance reporting and will be particularly useful in enabling the Health and Welfare Bureau to draw a direct comparison between the costs of SWD and those of non-governmental organisations, and to monitor the cost effectiveness of the latter. However, the Bureau is not sure whether DRAs can really help the Bureau achieve better policy decisions and resource prioritisation. The provision of social welfare services is determined primarily by the social needs of the community and that prudent commercial principles have only a partial relevance in the context of social welfare services. If there is a proven need for a particular service, the Bureau will have to put it in place, however high the full cost may be. The policy decisions and resource prioritisation are determined more by clients' needs than by cost considerations.
(g)	Security Bureau (as FSD's policy bureau)	The Security Bureau has reservations as to whether FSD is a suitable candidate for the pilot study, because FSD provides essential services with no private sector equivalent, and also because there is no other organisation with which to compare the full cost of providing the service. Cash cost is as good as full cost for cost trend comparison purposes as long as the basis of the calculation is consistent. Furthermore, benefits in terms of public safety reign over costs when it comes to matters of ensuring protection of life and property from fire and other dangers.

Source: Treasury's records

6.11 In December 1995, the SCFM concluded that the usefulness of DRAs should lie in bettering resource management. The SCFM decided that, in order to assess how DRAs could be used "as an internal management tool", the pilot study should be extended to include some other departments.

1996 extended pilot study

6.12 In April 1996, the Chief Secretary Committee's Public Services Policy Group endorsed the implementation of an extended pilot study. The six departments selected for the extended pilot study were: Department of Health (DH), Environmental Protection Department (EPD), Government Laboratory (GL), Government Land Transport Agency (GLTA), Information Technology Services Department (ITSD), and Printing Department (PD).

6.13 After DRAs for 1995-96 had been produced, four departments (namely the GL, GLTA, ITSD and PD) ceased to participate in the study, citing resource difficulties in producing the accounts as the reason. The remaining two departments, namely the DH and the EPD (confined to Waste Facilities Programme), continued to participate in the extended pilot study and produced DRAs for 1996-97 and 1997-98.

6.14 The main responses from the six departments involved in the extended pilot study, and those from their policy bureaux are summarised in Table 4 below.

Table 4

Responses from the six departments involved in the extended DRA pilot study and from their policy bureaux

	Department/ Bureau	**Responses**
(a)	DH	DRAs provide valuable information on: the full value of resources consumed; cost of interdepartmental services; and value of assets in DH. Such information leads to consideration of the cost effectiveness of certain services. However, DH is not in a position to account for resources like staff on-cost and costs incurred by other departments on its behalf, as very often DH has no flexibility in selecting service providers. Also, DH has limited flexibility in redeploying assets, and the condition of clinics cannot be reflected by their net replacement values. Besides, there is no positive return on net assets employed as most of DH's services are provided to the public either free of charge or with heavy subsidies.
(b)	EPD	DRAs are not particularly relevant as an internal management tool under the existing cash-based resource allocation and budgetary control mechanism. Controlling Officers do not have all the required power to control all spending or redeploy resources between departmental expenses and personal emoluments. However, EPD believes that DRAs will be a useful management tool when there are also parallel changes to the resource allocation and budgetary control mechanism.

Table 4 (Cont'd)

(c)	GL	DRAs provide a comprehensive picture of the full value of resources consumed. The performance indicators provide useful information on how GL performed. It will be desirable to include the performance indicators in quantifiable terms on the quality of GL's analytical work.
(d)	GLTA	DRAs provide the Agency with indicators to measure the cost efficiency and effectiveness of the various departmental activities.
(e)	ITSD	DRAs are a useful management tool for some organisations but its applicability for management decision is not directly relevant to the type of activities performed by ITSD. There are no significant benefits that ITSD can draw from it.
(f)	PD	DRAs will be a useful supplement to the other management information in use. In addition, DRAs will become helpful to decision-making as historical trend information will be established in future.
(g)	Planning, Environment and Lands Bureau (as the policy bureau of EPD and GL)	DRAs are a supplement to other existing indicators for the Planning, Environment and Lands Bureau to understand more about the financial performance of the departments under the Bureau's purview. However, full cost information is considered more relevant to the measurement of a department's performance if the department is run under a non-cash basis system, e.g. Trading Fund, or the department is given greater flexibility in managing its resources including assets. DRAs may be useful over a longer term when they establish a trend of expenditure figures.
(h)	Finance Bureau (as the policy bureau of GLTA, ITSD and PD)	The Finance Bureau supports the use of DRAs for GLTA, ITSD and PD. The Bureau considers that DRAs provide departments with the full cost incurred in the provision of services. Departments can use the historical trend figures to evaluate whether there is improvement in the cost effectiveness of their services and resource allocations. Furthermore, rates of return on capital employed can be obtained based on the net value of assets invested in departments. DRAs are relevant to the three departments and will facilitate the Bureau's longer-term policy decisions on changing them to Trading Funds. However, there are limitations in applying DRAs to them such as lack of yardsticks for measuring the cost effectiveness of services provided, and, in the case of ITSD, difficulties in drawing up cost efficiency indicators due to varying complexity of computer projects.

Table 4 (Cont'd)

(i)	Health and Welfare Bureau (as DH's policy bureau)	Some of the statements under DRAs are found to be quite useful in showing the breakdown of costs on different individual services, and providing a better picture on how the resources have been utilised. As the provision of health care services is determined primarily by the needs of the community rather than by cost or profit, DRAs only supplement other sources of information. DRAs will be more applicable to self-financing Trading Fund departments. The Health and Welfare Bureau has reservation about DRAs as a very useful internal management tool in DH.
(j)	Health and Welfare Bureau (as GL's policy bureau)	The Health and Welfare Bureau appreciates the provision of supplementary cost information in DRA reports. However, due to non-availability of the costs of testing charged by GL's commercial counterparts, this may limit the applicability of DRA reporting as a management tool for assessing the cost effectiveness of GL's operation.
(k)	Civil Service Bureau	Financial statements under DRAs should be quite useful in supplementing existing tools for monitoring the cost effectiveness of DH's activities and for planning purposes.

Source: Treasury's records

1999 Task Force on Review of Government's Financial Reporting Policy

6.15 In April 1999, a Task Force was set up to review the Government's financial reporting policy and to look afresh at the use of accrual accounting in the Government. The Task Force is chaired by the Secretary for the Treasury, with members from the Finance Bureau and the Treasury, including the Director of Accounting Services. The terms of reference of the Task Force are to:

— examine the background to the current standards of financial reporting of the Government;

— assess the adequacy of the existing financial reporting framework in the light of the agreed objectives of Government's financial reporting system, taking into account current and proposed standards and opinions of concerned parties;

— consider whether changes should be made to the published financial reports and, if so, identify the legal and practical implications involved, and whether such changes will have an impact on the current budgetary process; and

— **recommend to the Financial Secretary by the end of calendar year 2000 the standards and style of financial reporting for the Government and indicate an implementation plan and the costs thereof if necessary.**

6.16 The Task Force has a work plan which sets out its work time schedule, as follows:

Task	Time schedule		
Fact finding	April 1999	—	June 1999
Deliberations	June 1999	—	June 2000
Reporting	June 2000	—	September 2000

PART 7: AUDIT OBSERVATIONS AND RECOMMENDATIONS ON THE GOVERNMENT'S FINANCIAL REPORTING

Audit observations on the Government's review of financial reporting

7.1 As mentioned in Part 3 above, cash-based accounts, while capable of demonstrating the stewardship responsibility, are inadequate to meet other key objectives of financial reporting in the Government, including the accounting for value for money. As mentioned in Parts 4 and 5 above, the benefits of accrual-based accounts have been well established and it is becoming a trend for developed countries to move towards accrual accounting in public finance. **In this connection, Audit is concerned that, notwithstanding the Government's endorsement of the Working Group's recommendation in 1994 to implement DRAs (see paragraphs 6.3 and 6.4 above), and the subsequent completion of a consultancy and two pilot studies, DRAs have still not been implemented to date. Instead, a Task Force was set up in April 1999 to look afresh at the use of accrual accounting in the Government. Audit considers that there is a need for the Government to expedite action on this matter.**

Audit recommendations on the Government's review of financial reporting

7.2 **Audit has *recommended* that, in the Task Force's current review of the Government's financial reporting, the Secretary for the Treasury should:**

— **fully take into account the inadequacies of the cash-based financial reporting of the Government and the benefits of accrual accounting;**

— **expedite action on deciding whether or not to adopt accrual accounting in the Government and, if in the affirmative, draw up a definite timetable of implementation; and**

— **closely monitor the Task Force's work progress against its work plan to avoid slippage.**

Audit observations on implementation costs of changes in the Government's financial reporting

7.3 As stated in paragraph 6.15 above, the Task Force needs to consider whether changes should be made to the published financial reports and, if changes are considered necessary, indicate the costs of implementation. According to the Finance Bureau, the Task Force would consider whether DRAs are the best means of achieving the financial reporting objectives in Hong Kong's particular circumstances.

7.4 As mentioned in paragraph 6.8 above, in January 1995 the consultants estimated that the implementation costs for DRAs would be $51 million ($58 million at August 1999 prices) in the first year, with an annual recurrent cost of $27 million ($31 million at August 1999 prices) in subsequent years. The consultants considered that the implementation costs were not significant and a very small saving in the Government's expenditure would justify the costs.

7.5 **Given the relatively low cost of implementing DRAs and the growing public expectations for government departments to improve productivity, Audit is of the view that the Task Force should consider whether it is feasible for departments to absorb the cost of implementation, if DRAs are to be implemented. Audit is also of the view that a phased implementation approach would be appropriate to take into account departments' different circumstances (including their ability to absorb the implementation cost).** This phased implementation approach should also be considered by the Task Force in its deliberations of available options.

Audit recommendations on implementation costs of changes in the Government's financial reporting

7.6 Audit has *recommended* that, in assessing the various options of financial reporting in the Task Force's current review of the Government's financial reporting, the Secretary for the Treasury should:

- **consider whether it is feasible for departments to absorb the implementation costs through productivity enhancement; and**

- **consider implementation by phases so as to take into account departments' different circumstances (including their ability to absorb the costs of implementation).**

Audit observations on DRA pilot studies

7.7 With regard to the two pilot studies on DRAs which ended in 1998 (see paragraphs 6.9 to 6.14 above), Audit's examination of the relevant records indicated that there were deficiencies in the Government's assessment of the pilot studies. The audit observations are described in paragraphs 7.8 to 7.14 below.

DRAs as an internal management tool

7.8 **As stated in paragraph 5.2 above, accrual accounting can provide useful information to facilitate management decision-making.** In assessing the usefulness of DRAs as an internal management tool, the responses of the participating departments and their policy bureaux were mixed. Some of these departments and bureaux were supportive of the implementation of DRAs, while others raised reservations about their usefulness. Their responses are summarised in paragraphs 6.10 and 6.14 above. Audit's examination of their responses has indicated that the reasons given for not supporting DRAs are in general of doubtful validity. Audit's observations are described in paragraphs 7.9 to 7.13 below.

7.9 ***Limitation of the current budgetary control system (see items (b) & (e) in Table 3 and items (a), (b) & (g) in Table 4 above).*** The Works Bureau, the Planning, Environment and Lands

Bureau, the FSD, the DH and the EPD have indicated that, under the present budgetary control system, Controlling Officers do not have full control over all the resources needed to deliver their services. Audit considers that Controlling Officers have a duty to ensure the efficient and effective deployment of the resources under their control. Controlling Officers can control the use of their resources (albeit not fully) even under the present budgetary control system. For example, they can maximise the productivity of their work force by proper planning and work scheduling. They can also prevent the under-utilisation of government assets by, for example, identifying and returning surplus assets (e.g. office space or departmental quarters) to the appropriate authorities. DRAs can be used to help Controlling Officers better manage their resources even under the present budgetary control system. Furthermore, Audit notes that the Government is implementing a series of service-wide initiatives such as the one-line vote arrangement (Note 7) and civil service reform, which give Controlling Officers more flexibility in their use of resources. Audit considers that DRAs will provide a useful tool and impetus for the Government to move towards more flexibility in the deployment of resources, which will lead to better efficiency and effectiveness in the provision of public services. A further benefit of DRAs, as stated by the Finance Bureau, is that DRAs would facilitate longer-term policy decisions on changing some government departments to Trading Funds in order to improve the quality of service to customers (see item (h) in Table 4 above).

7.10 ***Difficulties in establishing cost efficiency indicators (see item (b) in Table 3 and item (h) in Table 4 above).*** The FSD has found it difficult to draw up cost efficiency indicators. The Finance Bureau has also reported that the ITSD has the same problem. However, Audit notes that the GLTA (see item (d) in Table 4 above) has a positive response, saying that "DRAs provide the Agency with indicators to measure the cost efficiency and effectiveness of the various departmental activities." Audit also notes that some departments have been successful in identifying measurable performance indicators as shown in the Controlling Officers' Reports in the annual Estimates. Moreover, other developed countries have made significant progress in the development of performance indicators. Audit considers that there is a need for the departments concerned to draw on the experience of other organisations (both local and overseas) in the development of performance indicators and, together with other management information provided by DRAs, make use of the performance indicators to effectively manage the departments' performance.

7.11 ***The absence of comparable cost indicators (see item (g) in Table 3 and items (h) & (j) in Table 4 above).*** The Security Bureau and the Health and Welfare Bureau have reported that there are no comparable cost indicators in the commercial sector for benchmarking the performance of the FSD and the GL respectively. The Finance Bureau has said that there is a lack of yardsticks for measuring the cost effectiveness of services provided by some departments. Audit considers that comparison with the commercial sector is not the only means to measure the performance of a government department. Other means include comparison of cost indicators of the department over time and comparison with standard costs. In Audit's view, DRAs can provide relevant cost information and thus are useful in this regard.

Note 7: *Starting from 1999-2000, a one-line vote arrangement has been introduced on a pilot basis for five departments, namely the Civil Service Training and Development Institute, Intellectual Property Department, Office of the Ombudsman, Hong Kong Police Force and Treasury. Under the one-line vote arrangement, all recurrent expenditure provided for the operation of a department is placed under a single subhead known as "Operational expenses", and the Controlling Officer is given flexibility in the deployment of funds, subject to the control on staff establishment.*

7.12 ***Services being provided on a need basis (see item (f) in Table 3 and item (i) in Table 4 above).*** The Health and Welfare Bureau has commented on services provided by the SWD and the DH. Regarding the SWD, the Bureau is of the view that "if there is a proven need for a particular service, we will have to put it in place, however high the full cost may be," and the Bureau is not sure whether DRAs can really help achieve better policy decisions and resource prioritisation. As regards the DH, the Health and Welfare Bureau has commented similarly by saying that "the provision of health care services is determined primarily by the needs of our community rather than cost or profit." As resources are scarce and there are competing needs in society, Audit considers that any policy decision has to be made with due regard to the costs and benefits. Furthermore, there may be different means of satisfying a specific need, and cost is always an important factor in determining the most cost-effective means to achieve an objective. DRAs are useful in providing the necessary cost information.

7.13 **Audit notes that, for the DRA pilot studies, the Finance Bureau had no clearly laid-down procedures for assessing participants' feedback. As a result, although the reasons given for not supporting DRAs were of doubtful validity, they were not critically assessed by the Finance Bureau and were not refuted. This may have led to the slow progress in implementing DRAs. Audit notes that in the Task Force's current review on financial reporting, the Task Force will seek and take into account the opinions of the parties concerned in determining the way forward. Audit is concerned that similar reasons may be given again by the parties concerned to oppose future proposals to change the basis of the Government's financial reporting. Audit considers that, in the current review, it is necessary for the Finance Bureau to draw up clear procedures for critically assessing feedback from the parties concerned.**

DRAs as a tool to enhance public accountability

7.14 As pointed out in paragraph 6.7(a) above, DRAs can be used to improve external performance reporting and public accountability. However, Audit notes that the assessment of the pilot studies by the departments and bureaux concerned was based predominantly on how DRAs can be used "as an internal management tool" (see paragraph 6.11 above). **As a result, due consideration was not given to the usefulness of DRAs from the perspective of public accountability. In Audit's view, this important aspect should have been adequately addressed.**

Audit recommendations on DRA pilot studies

7.15 **Audit has *recommended* that, in the Task Force's current review of the Government's financial reporting, the Secretary for the Treasury should:**

- **draw up clear procedures for critically assessing feedback from the parties concerned (see paragraphs 7.9 to 7.13 above); and**

- **apart from the use of DRAs as an internal management tool, give due consideration to the need for enhancing external performance reporting and public accountability (see paragraph 7.14 above).**

PART 8: RESPONSE FROM THE ADMINISTRATION

8.1 The **Secretary for the Treasury** has said that, as the subject of financial reporting of the Government is currently being considered by the Task Force comprising representatives of the Finance Bureau and the Treasury, this audit report provides timely and valuable input to the Task Force's deliberations. The Task Force will fully take into account the issues raised in this audit report. She has also said that:

Adequacy of the cash-based financial reporting of the Government

(a) the Finance Bureau has accepted previously that the existing cash-based accounts have certain shortcomings;

(b) in judging whether the Government's financial reporting information meets the needs of internal and external users, it is necessary to refer to the complete set of financial information produced by the Government, not just the published annual accounts;

(c) the published annual accounts demonstrate the Government's stewardship of its revenues received, and its compliance on the expenditure side with the appropriations approved by LegCo;

(d) information for policy making is prepared on an ad hoc basis, and does not rely on the information contained in the published accounts;

(e) for those fees and charges which are set on a full cost recovery basis, it is specified in the Costing Manual issued by the Director of Accounting Services that the related costs should be compiled in line with the accrual basis;

(f) ad hoc exercises related to the contracting-out of services may need to focus on the marginal costs and benefits of such change to the existing arrangements, instead of full costs;

(g) the Medium Range Forecast published annually at the time of the Financial Secretary's Budget Speech helps demonstrate to external parties the Government's overall financial health and ability to sustain its expenditure programmes;

(h) regarding the Government's use of resources, the annual Estimates contain targets and key performance indicators, and the draft Estimates are subject to detailed examination by LegCo Members during the special meetings of the Finance Committee convened for this purpose;

International developments in public financial reporting

(i) for countries which have moved from the cash basis of accounting to the accrual basis, the changes have not been made in isolation but have been part of a wider process of public sector reform suited to the particular needs of the countries concerned (Note 8);

(j) the public sector reforms implemented in some overseas countries include significant organisational changes and adoption of full cost appropriations, which necessitated and gave impetus to a switch to accrual accounting;

(k) in overseas countries, it is difficult to separately assess the benefits arising from the implementation of accrual accounting, because the change has often been accompanied by wider reforms;

(l) the Finance Bureau cannot assume that the reforms suited to other countries will necessarily be appropriate in the local particular circumstances. However, it does not mean that the Finance Bureau cannot learn from the experience of other countries to determine the best way forward for Hong Kong;

(m) the Task Force working on this subject needs to take account of the above implications. It has started with a clean slate and has an open mind on the way forward;

The Government's review of financial reporting

(n) in conducting its review, the Task Force will pay due regard to the shortcomings of the cash-based accounts and will examine carefully what benefits could arise from a change to the accrual basis of accounting;

(o) the Task Force will carefully consider the range of needs of all parties when considering the way forward for the Government's financial reporting;

(p) the work of the Task Force is not straightforward. It needs time to do its work thoroughly with a view to compiling a set of well-argued and sensible recommendations;

(q) although she would like to see that the Task Force completes its review earlier, she considers that it is not practicable for the Task Force to finalise its work effectively before the end of 2000;

Note 8: *As stated in paragraph 7.9 above, the Government is implementing a series of service-wide initiatives such as the one-line vote arrangement and civil service reform. Audit considers that the implementation of these initiatives calls for the adoption of accrual accounting which provides a useful tool to help departments and bureaux better manage their resources.*

Implementation costs of changes in the Government's financial reporting

(r) under the Enhanced Productivity Programme, by 2002-2003, departments are required to continue to perform all their existing functions but with five per cent less money. This five per cent saving will be returned to the Government to fund new activities accorded priority in the interests of the overall community. Departments may have difficulties in absorbing the costs involved in implementing changes in the Government's financial reporting;

(s) the Finance Bureau needs to examine closely the costs and benefits involved in changing the Government's financial reporting;

(t) if the Task Force decides that changes to the Government's financial reporting are needed, it will examine how the costs can be met and whether a phased implementation would be most suitable;

DRA pilot studies

(u) the DRA pilot studies were seen as being of very limited value;

(v) the decision not to further pursue the pilot study was not taken because of the responses of the departments and bureaux concerned. A lukewarm response from bureaux and departments would on its own be no justification;

(w) there were two main reasons which led to the decision not to further pursue the pilot study, namely recognition of the need for a centrally coordinated review similar to that now embarked upon by the Task Force, and recognition of the immediate resource constraints which departments and bureaux would face in the context of the implementation of the Enhanced Productivity Programme;

(x) she believes that Controlling Officers are to some extent correct when they suggest that they do not have total control over the full costs of running their departments. For example, their staff are remunerated according to service-wide terms and conditions, and decisions on how their accommodation needs should be met are made in the context of getting the best value for money out of the Government's estate as a whole (Note 9); and

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Note 9: *Audit considers that even under the present budgetary control system, full cost information arising from accrual accounting can help Controlling Officers better manage their resources (see paragraph 7.9 above).*

(y) she agrees that in the Task Force's review proper weight should be given to the issue of public accountability and the need to provide financial information which promotes sound financial management throughout the Government.

8.2 The **Director of Accounting Services** has said that:

International developments in public financial reporting

— there is very little published evidence that accrual accounting in itself has achieved major benefits for countries and public sector entities that have adopted it (Note 10);

— the real benefits arising from adopting accrual accounting in overseas countries have come from public sector reforms which have demanded accrual accounting as a by-product of the reform processes (see Note 8 in sub-paragraph 8.1(i) above);

— it is not accrual accounting alone that would be conducive to improvements in overseas governments or government departments in Hong Kong, but rather a fairly radical change in the way that Heads of Department are held accountable for their expenditure; and

DRA pilot studies

— based on departments' reaction to the DRA pilot studies, there was a limit to what a Controlling Officer could do as many of the costs involved were beyond his control. Such costs include salaries of general grade staff, salary on-cost, and accommodation cost. These costs can amount to 80 per cent of the total expenditure attributable to the Controller Officer's activities (see Note 9 in sub-paragraph 8.1(x) above).

Note 10: *The limitations of cash accounting and the benefits of accrual accounting, as stated in Parts 3 and 5 above, are the published findings and views of internationally renowned organisations. Similar findings and views have been made by the Working Group (1993) on Financial Reporting and the consultants which the Government commissioned (in 1994) to study the implementation of DRAs in the Government. Furthermore, the Secretary for the Treasury has said that the existing cash-based accounts have certain shortcomings, and that the Task Force will examine carefully what benefits could arise from a change to the accrual basis of accounting (see sub-paragraphs 8.1(a) and 8.1(n) above).*

8.3 With regard to the DRA pilot studies, some of the **participating departments and their policy bureaux** have responded to the audit findings. In their responses, they have generally agreed that accrual accounting has benefits. However, they have also indicated that:

— there is a need for an appropriate computerised management information system to support the implementation of DRAs;

— there are constraints on bureaux and departments in controlling the use of resources under the existing budgetary system;

— there are difficulties in absorbing the costs of implementing changes in the financial reporting system; and

— there are difficulties in identifying cost efficiency indicators.

Details of their responses are at Appendix C.

Appendix A
(paragraph 2.2 refers)

Funds established under section 29 of the Public Finance Ordinance

Eight funds have been established under section 29 of the Public Finance Ordinance. They are:

(a) ***Capital Investment Fund.*** The Fund finances investments in and loans to public sector bodies which are not part of the Government's structure and such other bodies as the Finance Committee may specify;

(b) ***Capital Works Reserve Fund.*** The Fund finances public works programmes, acquisitions of land, capital subventions, and major systems and equipment items;

(c) ***Civil Service Pension Reserve Fund.*** The Fund is intended to meet payment of civil service pensions in the most unlikely event that the Government cannot meet such liabilities from the General Revenue;

(d) ***Disaster Relief Fund.*** The Fund provides a ready mechanism for Hong Kong to respond swiftly to international appeals for humanitarian aid in relief of disasters that occur outside Hong Kong;

(e) ***Innovation and Technology Fund.*** The Fund finances projects that contribute to innovation and technology upgrading in the manufacturing and service industries, as well as those that contribute to the upgrading and development of these industries;

(f) ***Land Fund.*** The Fund enables the investments held by the former Trustees of the Hong Kong Special Administrative Region Government Land Fund to be formally brought into the Government's accounts;

(g) ***Loan Fund.*** The Fund finances loans and advances for schemes of developments in Hong Kong and loans to students at selected post-secondary institutions under schemes approved by the Finance Committee; and

(h) ***Lotteries Fund.*** The Fund finances social welfare services by grants, loans and advances.

Source: "Accounts of the Government" published by the Treasury

Appendix B
(paragraph 3.1 refers)

Member countries of the OECD

Australia	Germany	Luxembourg	Switzerland
Austria	Greece	Mexico	The Netherlands
Belgium	Hungary	New Zealand	Turkey
Canada	Iceland	Norway	United Kingdom
Czech Republic	Ireland	Poland	United States
Denmark	Italy	Portugal	
Finland	Japan	Spain	
France	Korea	Sweden	

Source: The OECD

Responses from departments involved in the DRA pilot studies and from their policy bureaux

1. The **Director of Architectural Services** has said that:

(a) a computerised management information system should be developed to support the production of DRAs on a service-wide basis; and

(b) departments' ability to absorb the costs of implementing DRAs would depend, to a great extent, on the functions and features of the new computerised system.

2. The **Director of Fire Services** has said that:

(a) while there is no dispute over the many advantages arising from adopting accrual accounting as identified by various professional bodies, the financial implications of the implementation should not be overlooked;

(b) under the Enhanced Productivity Programme, departments are facing extreme stringency in their internal resource and this may pose difficulty for them to absorb the development cost;

(c) considerations should be given to incorporating cash and accrual accounting systems into the Government's Financial Management Information System currently being reviewed by the Director of Accounting Services;

(d) as the majority of departmental expenditure is controlled under the conventional head and sub-head system, the flexibility and delegated authority conferred upon Controlling Officers for redeploying resource under their control are subject to a lot of constraints imposed by the various regulations in place;

(e) although Controlling Officers have the duty to ensure the efficient and effective deployment of the resources under their control, the Secretary for the Treasury and the concerned policy bureau have more say in deciding the deployment of new and existing resource of departments;

(f) for the FSD, there is no comparable service in the private sector. Hence, comparison of cost effectiveness of services with other similar service providers is of no avail;

(g) as the FSD is providing unique and essential public service to protect life and property from fire or other calamity, service demands are quite difficult to project; and

(h) the complexity of each call for service varies and the extent of damage is beyond prediction. Hence, it would be inappropriate to ascertain the cost effectiveness of fire fighting and rescue services by using the commonly adopted approach.

3. The **Director of Information and Technology Services** has said that:

(a) he agrees that DRAs would provide useful full cost information in general. However, the applicability of DRAs to management decision-making is not directly relevant to the activities undertaken by the ITSD because:

(i) there are costs which are not controllable by the ITSD. An example is accommodation cost. While Controlling Officers can determine how best to utilise office space allocated to their departments, they cannot plan for the acquisition of the most cost-effective office spaces. Another example is the Central Administrative Overhead allocated from other central administrative departments, which is beyond the control of the Controlling Officers;

(ii) DRAs may not help the ITSD in resource bidding and budgetary control as these still rely on cash-based reports; and

(iii) some of the ITSD's activities, such as the provision of technical advice to government departments and the promotion of the use of information technology in the Government and in the community, are difficult to quantify. There is no doubt that the experience of other departments can serve as a useful reference in the development of performance indicators. Cost efficiency indicators are applicable to activities of a repetitive nature and those which can be easily calibrated in terms of cost. Where the activities are not of this nature, it may be difficult, if not impossible, to define meaningful cost efficiency indicators; and

(b) with the implementation of the Enhanced Productivity Programme in the four years from 1999-2000 to 2002-2003, the ITSD will find it difficult to absorb the DRA costs.

4. The **Director of Social Welfare** has said that:

(a) accrual-based accounts can complement the existing cash-based accounts and provide additional information to bring about the benefits mentioned in paragraph 6.7 above; and

(b) however, the additional effort to produce accrual-based accounts should not outweigh the benefits. If the additional effort is substantial, the SWD would not be able to absorb it.

5. The **Secretary for Health and Welfare** has said that on the whole, the Health and Welfare Bureau appreciates that accrual accounting has its own benefits. These benefits, however, may not be strictly applicable to the situation in Hong Kong. As such, the Bureau has reservations as to whether further implementation of accrual accounting should be pursued and the Bureau's previous comments on DRAs (see item (f) in Table 3 of paragraph 6.10 and items (i) and (j) in Table 4 of paragraph 6.14 above) remain valid. He has also said that:

(a) each country has its own unique characteristics and policy focus. The conclusions drawn by the OECD and IFAC, while true for some countries, are not necessarily valid for Hong Kong;

(b) some of the developed countries mentioned in Table 2 in paragraph 4.6 above have not yet announced plans to adopt the accrual basis for budgetary control. There must be reasons for them not doing so. The departmental accounts in Hong Kong are largely for serving budgetary purposes. The cash accounting currently adopted is in fact serving meaningful purposes;

(c) the need to reflect the true financial commitments and liabilities is strong in many countries because most of them have national borrowings. As the Government hardly has any external debts, the need to reflect commitments and liabilities through accrual accounting is not obvious;

(d) many developed countries have national industries. It is useful to use full costs to compare the performance of these industries with their commercial counterparts. In Hong Kong, the situation is different. Most of the health and welfare services are provided in the public sector. For expenditure on capital projects, the Health and Welfare Bureau is adopting a system which differentiates "commitments" from "cash flow". The system is already moving from the pure cash basis;

(e) whether the cost of implementing DRAs is high or low should be better evaluated in the light of needs and benefits; and

(f) if comparison of cost indicators were to be made between different periods and within the same sector, cash-based costing could still serve the purpose of comparison, so long as the definition of “cost” remains consistent over the period. Accrual accounting may only provide marginal improvement (see Note below).

<u>Note to paragraph 5 above</u>: Audit notes that internationally renowned organisations have clearly established the limitations of cash accounting and the benefits of accrual accounting (see Parts 3 and 5 above). In Hong Kong, similar findings and views have been made by the Working Group (1993) on Financial Reporting and the consultants which the Government commissioned (in 1994) to study the implementation of DRAs in the Government. Furthermore, the Secretary for the Treasury has said that the existing cash-based accounts have certain shortcomings, and that the Task Force will examine carefully what benefits could arise from a change to the accrual basis of accounting (see sub-paragraphs 8.1(a) and 8.1(n) above).

6. The **Secretary for Planning, Environment and Lands** has said that:

(a) the introduction of DRAs on a government-wide basis is unlikely, by itself, to bring about the benefits on improved performance reporting, better decision-making on resource allocation, enhanced financial management practices, etc., unless it is accompanied by the development of a user-friendly computerised financial management information system. For this to happen, an early decision needs to be made on the appropriate structure for reporting the Government’s financial management information; and

(b) at present the Government’s financial management information is based on policy areas and programmes. However, the Performance Review System currently being developed is based on Policy Objectives and Key Result Areas. These need to be brought into line and developed in a common system that makes useful financial information readily available to managers at all levels in the Government.

7. The **Secretary for Works** has said that the Works Bureau is of the view that, although accrual accounting can be used in some special circumstances (e.g. Trading Funds and government utilities), as long as the current budgetary process remains unchanged, DRAs will only have a supplementary role to play in internal management, especially at the bureau level.

Appendix D

Acronyms and abbreviations

ASD	Architectural Services Department
ASOSAI	Asian Organisation of Supreme Audit Institutions
DH	Department of Health
DRAs	Departmental Resource Accounts
EPD	Environmental Protection Department
FSD	Fire Services Department
GL	Government Laboratory
GLTA	Government Land Transport Agency
GRA	General Revenue Account
IFAC	International Federation of Accountants
INTOSAI	International Organisation of Supreme Audit Institutions
ITSD	Information Technology Services Department
LegCo	Legislative Council
OECD	Organisation for Economic Cooperation and Development
PD	Printing Department
PFO	Public Finance Ordinance
SCFM	Standing Committee on Financial Management
SWD	Social Welfare Department