Chapter 1: Accounting Policy Choice in the Australian Public Sector

1.1 Introduction

When viewed in its simplest form, this research study addresses the adoption of accrual reporting in the financial statements of Australian Commonwealth departments. Such research is valuable because, as discussed in Section 1.3, the financial reporting framework for public sector entities is still in a state of flux and further developments have been foreshadowed.

Taking a wider perspective, this dissertation also analyses and opens the way for the application of the vast amount of research conducted on private sector accounting policy choice to the Australian public sector.

A utility maximisation approach is adopted as the basis of this study, acknowledging the influences of both economic and social factors on the utility of those responsible for the preparation of departmental financial statements.

Previous studies addressing accounting policy choice in the Australian public sector have relied on a branch of economic rationalist theory developed in relation to municipal governments in the United States of America (USA). Chapter 2 of this dissertation assesses the validity of such an approach and provides sound reasons as to why the framework developed for analysis of private sector accounting policy choice is more relevant to the Australian Commonwealth public sector. Section 1.4 provides a brief outline of the basis for this conclusion.

In Chapter 3 the private sector framework outlined in Chapter 2 is applied to the introduction of accrual reporting in the financial statements of Commonwealth departments. This event constitutes a particularly useful case study because the adoption of accrual reporting was implemented over a period of three years. Departmental

Secretaries were able to choose the financial period in which accrual reporting was first adopted within that time frame. As outlined in Section 1.2, the policy choice was clearly visible and was likely to represent a significant outlay of resources.

The analysis contained in Chapter 3 resulted in a focus on two factors, being:

1. the cost of adopting accrual reporting and

2. the 'political visibility' of the department,

where ''political visibility' is defined as:

> the relative share of scrutiny by politicians, organised groups such as trade unions, and the general public

Chapter 4 provides details of the methods employed to empirically test the research propositions developed in Chapter 3. These methods are summarised in Section 1.5, and include the development of five new proxies for 'political visibility'. These proxies take advantage of the strong accountability mechanisms operating in the Commonwealth public sector. The limitations associated with these proxies are also discussed in Chapter 4.

Chapter 5 contains a discussion and analysis of the results of the statistical tests conducted. These results and their implications are summarised in Section 1.6. Detailed data and statistical analysis tables are provided in the Appendices.

Chapter 6 provides an overview of this dissertation, and identifies avenues for future research. Though, as with all empirical research, there are a number of limitations associated with the findings of this study, the potential benefits to be obtained from

pursuing the arguments presented in this paper are significant, not least because of the introduction of accrual reporting across the public sector in Australia.

1.2 The Move to Accrual Reporting by Commonwealth Departments

The introduction of accrual reporting for Commonwealth departments is the most recent of a number of dramatic changes in the financial reporting responsibilities of Commonwealth departmental Secretaries over the last five or six years.

Though since 1970 most departmental Secretaries voluntarily prepared annual reports on the activities and achievements of their departments, it was not until 1985, with amendments to section 25 of the *Public Service Act 1922,* that the timely preparation and provision of annual reports became mandatory. The annual reports were required to comply with guidelines which were prepared by the Department of the Prime Minister and Cabinet and approved by the Joint Committee of Public Accounts (JCPA) (Senate Standing Committee on Finance and Public Administration (SSCFPA) 1989, pp. 3-5).

The approved guidelines contained more than thirty specific requirements, covering a broad range of matters including freedom of information, social justice reporting and industrial democracy (SSCFPA 1989, p. 9). However, it was not until the 1988-89 financial year that any form of financial information was included in these documents.

Instead, prior to 1988-89, the Minister for Finance reported cash receipts and payments against the annual Budget, for each department and for each of the three central funds (Department of Finance (DoF), 1994b, p. 2).

In 1989 section 50 of the *Audit Act 1901* was amended to require the Secretaries of departments to include audited financial statements in their annual report, prepared in accordance with guidelines issued by the Minister for Finance.

These financial statement guidelines adopted a 'modified cash' basis of reporting, requiring the disclosure of receipts and payments against the Budget for each fund, together with additional disclosures in relation to an increasing range of assets and liabilities. For example, the 1989-90 financial statements of departments were required to disclose information on cash, receivables, investments, inventories, furniture, fittings and plant (DoF 1990, paras. 3.6.4-3.6.20). However, assets under operating leases, lease improvements, land, building and infrastructure assets were not required to be disclosed (DoF 1990, para. 3.6.24). By 30 June 1992, departments were required to disclose information on land and buildings if rental was being received on these assets. It was also stated at that time that all exclusions would be removed by 30 June 1994 (DoF 1992b, para. 3.6.34).[1]

Throughout this period, there was increasing discussion on the possible application of accrual concepts to the financial statements of departments, such as in the 1986 Australian Society of Accountants annual research lecture and 1987 Australian Society of Accountants briefing (Carpenter, G.J. 1986; Regan 1987; Shand 1987).

In February 1991 a working party consisting of representatives from DoF, each State and Territory Treasury or Ministry of Finance, the Australian Bureau of Statistics and the

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[1] It is interesting to note that the exclusion for infrastructure assets was subsequently extended past the 30 June 1994 deadline (DoF 1993c, para. 3.6.29), and was further expanded to cover heritage assets (DoF 1994d, para. 3.6.30). The current situation is that infrastructure and heritage assets need not be recognised in the balance sheets until 30 June 1997 (DoF 1995a, cl. 3(1)(c)(v)).

Australian Accounting Research Foundation (AARF), was created to consider issues associated with accrual accounting in the public sector (Working Party on Accrual Accounting 1992, p. 1).

AARF issued a discussion paper on the topic in March 1991 (Sutcliffe, Micallef & Parker 1991), and the subsequent exposure draft was issued in January 1992 (AARF 1992a).

Meanwhile, other jurisdictions were already implementing accrual reporting. For example, the NSW state government began implementing accrual reporting for its government departments in 1990, also allowing a time frame of only three years (Mackintosh 1992, pp. 14-17). Similarly, the neighbouring New Zealand government undertook radical changes to its public sector management framework from 1986, and by June 1992, all New Zealand Departments accounted and budgeted on a full accrual basis (Mackintosh 1992, pp. 17-20).

Against this background, in November 1992 the Minister for Finance announced that all Commonwealth government departments were to move to financial reporting on an accrual basis. It was intended that all departments were to achieve this goal by 30 June 1995. (DoF 1994a, p. 20).

Though the financial statement guidelines determining the form of the accrual financial statements were not issued by the Minister for Finance until May 1993, ten departments did report on that basis for the 1992-93 financial year. A further sixteen departments adopted full accrual reporting for the 1993-94 financial year[2].

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[2] See Table 2 on page 50 for a listing of those departments which adopted accrual reporting prior to 1994-95.

In December 1993, AARF issued *Australian Accounting Standard AAS 29 - Financial Reporting by Government Departments* (AAS 29) (AARF 1993), specifying an operative date of the first reporting period ending on or after 30 June 1996. This standard was generally compatible with the format and concepts contained in the Minister for Finance's accrual reporting guidelines, and so adoption of AAS 29 by Commonwealth departments was mandated for financial reporting periods ending on or after 30 June 1995 (DoF 1995b, p. 1).

A time-line of the key events is contained in Figure 1.

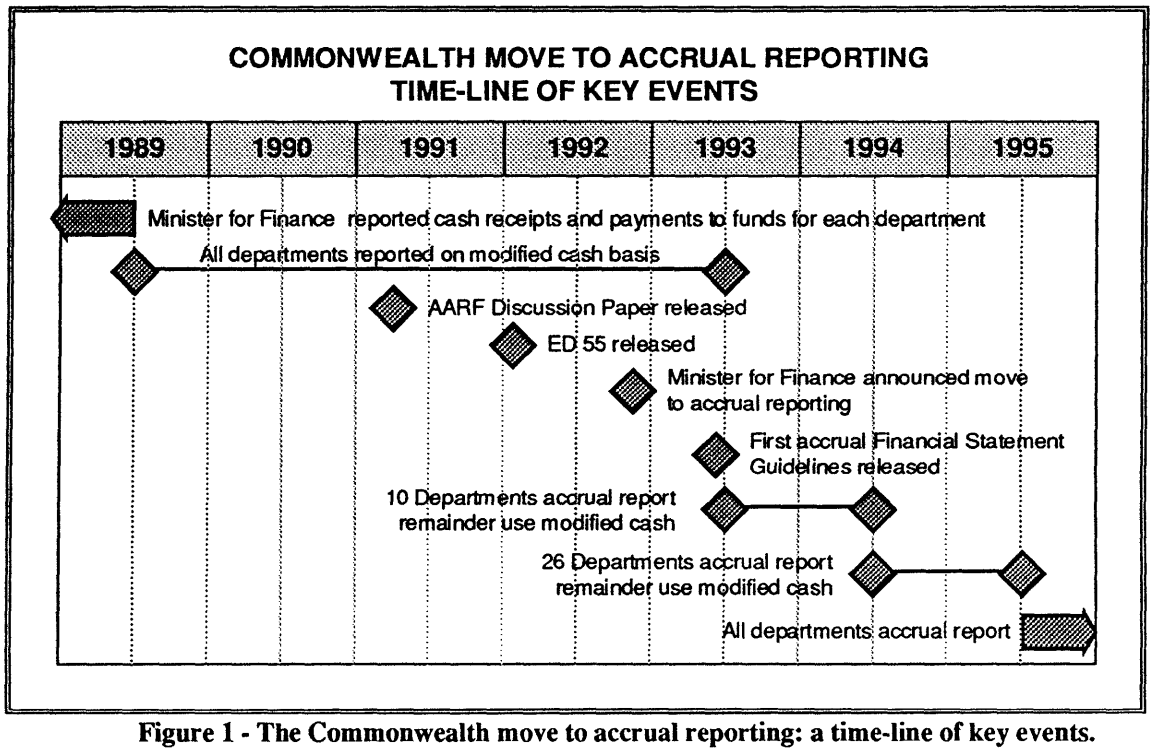

Figure 1 - The Commonwealth move to accrual reporting: a time-line of key events.

1.3 Why Explore Accounting Policy Choice in the Australian Public Sector?

The time-line in Figure 1 clearly illustrates that the change in the Commonwealth reporting framework for government departments has been quite dramatic and was implemented over a relatively short period of time. Despite the costs involved, a total of twenty six departments adopted accrual reporting prior to the mandated date, ten of

those doing so within eight months of the initial announcement that accrual reporting was to be adopted by Commonwealth departments.

This dissertation addresses the political, economic and social incentives of those responsible for the financial reporting practices of government departments. By focusing on factors which may have led to an assessment that the benefits of early adoption of a recommended practice outweighed the costs, the potential is created to contribute to the development of strategies which will encourage acceptance of future proposed developments.

That such strategies will be needed is quite clear, as accounting standard setting for the public sector in Australia has a relatively short history. The first specific standard, covering financial reporting by local governments was issued in July 1991 (AARF 1991), the accounting standard for financial reporting by government departments was issued in December 1993 (AARF 1993) and an exposure draft on reporting on whole of government activities was issued in March 1995 (AARF 1995).

There are currently a number of significant developments occurring in public sector financial reporting in Australia. The most noteworthy of these is the method of asset valuation to be adopted. Though accounting standard setting bodies have not yet issued comprehensive guidance on the valuation of assets within the conceptual framework for general purpose financial reporting[3] the government sector has addressed this issue unilaterally.

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[3] AARF has currently issued four Statements of Accounting Concepts within the conceptual framework project for general purpose financial reporting. The topics covered are the definition of the reporting entity (AARF 1990a), the objective of general purpose financial reporting (AARF

In 1994 a set of guidelines entitled *Guidelines on Accounting Policy for Current Valuation of Assets of Government Trading Enterprises* (Steering Committee on National Performance Monitoring of Government Trading Enterprises 1994) were published. These guidelines outline a deprival valuation methodology[4], and are expected to be mandated by all States, Territories and the Commonwealth for their government trading enterprises and for most other public sector entities.[5] The Commonwealth has signalled that this methodology has strong support by encouraging its adoption in the financial statement guidelines for both government departments and Commonwealth Authorities (DoF 1995a, cl. 6(3); DoF 1995b, p. 14; DoF 1995c, cl. 6(3)). Such a step will place public sector entities at the forefront of financial reporting developments.

In addition, though the introduction of accrual reporting to the public sector may provide '*...a more complete picture of an organisation's financial performance and financial position.*' (DoF 1994a, p. 19) a Pandora's box of choices has been opened. Such choices include the determination of depreciation rates, capitalisation of intangible assets such as goodwill and research and development projects, and measurement of non-monetary liabilities such as employee provisions for long-service leave and sick leave.

1990b), the qualitative characteristics of financial information (AARF 1990c) and the definition and recognition of assets, liabilities, revenues, expenses and equity (AARF 1992b).

4 See DoF 1994b, p. 22 or Hodgson, Holmes & Kam 1992, pp. 80-86, for an overview of the meaning of 'deprival value'. For a detailed discussion of the intended application to the public sector in Australia, the guidelines should be referred to directly (Steering Committee on National Performance Monitoring of Government Trading Enterprises 1994).

5 I am aware of this move as a result of representing the Commonwealth Department of Finance at the State-Treasuries Liaison Committee on Accounting Matters in 1994, where this specific question was raised.

These matters, which still prove controversial in the private sector[6], are likely to prove even more contentious in the traditionally prescriptive reporting environment of the public sector.

It is important to be able to identify factors which are likely to influence such decisions so that methods to address potential manipulation of results can be developed. As discussed in Section 1.4, the first steps to meeting this need are provided in this dissertation by preparing the way to apply prior private sector accounting policy choice research to future analysis of accounting policy choice in the Australian public sector.

1.4 Accounting Policy Choice by Bureaucrats or Politicians?

Chapter 2 of this dissertation compares and contrasts the application of accounting policy choice theory in the private sector to that developed specifically for application to the public sector.

In the private sector, the manager of the firm is viewed as being responsible for the accounting policy choices reflected in the financial statements. Such choices are assumed to be made based on the impact that they will have on his personal utility.

In the public sector, accounting policy choices have traditionally been viewed as the domain of an elected representative who has policy responsibility for the services delivered by the government agency. Again it is assumed that such choices will be made on the basis of the impact that they will have on his personal utility.

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[6] See, for example, Mathews and Perera 1993.

Chapter 2 analyses the reporting and accountability structure which exists in the Commonwealth public sector. The conclusion resulting from this analysis is that, in this environment, it is the appointed bureaucrat, the departmental Secretary, who is responsible for the accounting policy choices reflected in departmental financial statements.

In addition, Chapter 2 identifies strong analogies between:

1. a firm and a government department, and

2. the manager of a firm and a departmental Secretary.

These conclusions mean that the wealth of research conducted in relation to the private sector is now available for application to investigations into accounting policy choice in the Australian public sector.

However, though the broad framework has been shown to be applicable, there are certain distinctions in the environment which require further investigation. One such distinction suggested in this research paper is that the influence of 'political visibility' may not apply solely as predicted in private sector research.

Prior research has generally implied that the managers of firms will take action to reduce the political visibility of their firm to reduce the potential imposition of additional political costs.[7] However, the findings of this study, as outlined in Chapter 5, suggest that though this influence may apply to Secretaries of departments, there are also

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[7] This is discussed in detail in Section 2.2.3 - The Introduction of Political Costs, on page 25

indications that the Secretaries of departments which are not politically visible will, in fact, take action to increase the political visibility of their department.

The basis upon which the above suggestions are made is discussed in more detail in Section 1.5.

1.5 Economic Rationalist Behaviour and the Adoption of Accrual Reporting by Departmental Secretaries

Chapter 3 applies the private sector framework for accounting policy choice to the timing of the decision by departmental Secretaries to adopt accrual reporting.

This analysis resulted in two propositions:

Proposition 1: **the physical cost of adopting accrual reporting influenced the timing of the decision made by the departmental Secretary to adopt accrual reporting**

and

Proposition 2: **the political visibility of the department influenced the timing of the decision made by the departmental Secretary to adopt accrual reporting.**

Having regard to the way in which the cost of the move to accrual reporting and the political visibility of a department could be measured, these propositions were subsequently developed into research questions:

Research Question 1:
Did those departments which adopted accrual reporting early have a higher 'ability to pay' than the other departments?

and

Research Question 2:
Did the political visibility of those departments which adopted accrual reporting early differ from the political visibility of the other departments?

To empirically test these research propositions, proxies for the concepts 'ability to pay' and 'political visibility' were developed.

The proxy for 'ability to pay', being revenue per employee, was based on prior research, and provided an indication of the relative level of resources available to the departmental Secretary to implement accrual reporting.

Two of the proxies for 'political visibility', being size and number of employees, were also based on prior research. The remainder were specifically created to take advantage of the high level of accountability mechanisms which operate in the public sector. Such mechanisms include:

1. the right for aggrieved parties to complain to the Commonwealth Ombudsman in relation to decisions made by officers of the department,

2. the right of access to information held by the department which is provided under the *Freedom of Information Act 1982*,

3. financial statement and other audits conducted by the Australian National Audit Office, and

4. investigations conducted by Parliamentary Committees.

A further proxy for political visibility was developed which was a composite of the other proxies. An overview of the variables used to represent the proxies is contained in Table 5 - Summary Description and Source of Independent Variables, on page 104.

Data was collected over three time periods:

1. 1991-92: the financial year before the announcement that accrual reporting was to be introduced for departmental financial statements,

2. 1992-93: the financial year in which the announcement was made and for which the first ten departments adopted accrual reporting, and

3. 1993-94: the final financial year for which departments could voluntarily adopt accrual reporting. From 1994-95, accrual reporting was mandated for application to departmental financial statements.

A number of hypotheses were developed to test each research question, addressing each time period and each proxy separately. The hypotheses in relation to Research Question 1 were tested using parametric statistics, whilst non-parametric statistics were used to test the hypotheses in relation to Research Question 2.

A brief summary of the results of the testing of these hypotheses is provided in Section 1.6.

1.6 Political Visibility in the Commonwealth Public Sector

Chapter 5 provides the detailed results of the empirical tests conducted. These results did not identify a statistically significant difference between the 'ability to pay' of those departments which adopted accrual reporting early and the other departments. However, straight mathematical methods did indicate that those departments which adopted accrual reporting in the first year that such reporting was allowed did have a slightly higher revenue per employee than did the remaining departments.

In relation to political visibility, the statistical tests indicated that those departments which adopted accrual reporting in the first possible year generally had lower political

visibility than the sample median. One tentative conclusion that can be drawn is that political visibility did influence the decision of departmental secretaries to adopt accrual reporting, and that early adoption may have been used as a mechanism to raise the political visibility of these low profile departments.

This result highlights a distinction between the private sector and the public sector, being that the latter operate in a truly political environment in which to be politically 'invisible' may be as detrimental as being highly political visible.

At the same time, as the proxies which were used to measure political visibility are also indicative of political costs, the result may also be an indication that those departments which adopted accrual reporting early had relatively less demands on their departmental funds and so more funds available to change their accounting systems, thus providing some indirect support for Research Question 1.

The opposite conclusion, however, is drawn for those departments which adopted accrual reporting in the second year, as these departments generally had a higher level of political visibility than the sample median, implying a higher level of political costs and thus relatively higher demands on departmental funds.

Thus the overall conclusion drawn is that though the physical costs may have had an influence on the timing of the decision to adopt accrual reporting, this cost was overridden by the influence of political visibility. This finding is consistent with prior research discussed in Section 3.3.

1.7 Summary

This introductory chapter has provided a brief outline of a research project conducted into the early adoption of accrual reporting in the financial statements of Commonwealth departments.

The results of this study suggest that, with some modification, theories relating to private sector accounting policy choice can be applied to the accounting policy choices reflected in departmental financial statements.

The rest of this dissertation describes the basis upon which the above conclusion was drawn. There are a number of limitations, including the appropriate interpretation of the proxies used and whether or not the sample was representative of the population. These limitations are discussed in detail throughout Chapter 4, Chapter 5 and Chapter 6.

However, with the introduction of accrual reporting to many segments within the public sector throughout Australia, across local and state governments, as well as the Commonwealth, the way has been opened for this claim to be further investigated in a variety of accounting policy choice scenarios.

Chapter 2: Every Man for Himself

> (Money) The last enemy that shall never be subdued. While there is flesh there is money - or the want of money, but money is always on the brain so long as there is a brain in reasonable order.
>
> Samuel Butler II

2.1 Introduction

The objective of this research study is to address and identify selected factors which may have contributed to the early adoption of a recommended accounting policy in the Commonwealth public sector.

The adoption of accrual reporting is treated as an instance of accounting policy choice in the presentation of financial information in external reports. One of the dominant paradigms of research in this area is the theory of utility maximisation, and it is this approach which is investigated in this paper.

It should be stated at the outset that the concept of utility maximisation as used in this paper incorporates both economic rationalist behaviour in its purest form, ie. with a focus on monetary rewards, and also consideration of the fact that actions may have implied cultural or social costs and/or benefits.

The Covenant upon which such theories are based is that individuals act in their own self-interest. Stated simply, rational economic beings will only act to move from their current position if the marginal benefits of such actions outweigh the marginal costs (Watts and Zimmerman 1978).

It is not difficult to accept this assumption, but it is in its implications that there is great scope for intuition, and conjecture.

This chapter addresses how this key precept has been integrated into theories of accounting policy choice. Section 2.2 describes the theory developed to explain

accounting policy choice in the private sector and Section 2.3 describes the theory developed in relation to the public sector.

As outlined in Section 2.2, accounting policy choice research in the private sector treats the financial statements as being under the control of the firm manager. Choices reflected in those financial statements are considered to be made so as to maximise the utility of the firm manager.

Section 2.3 describes how, in public sector accounting policy choice research, the financial statements of a government agency are viewed as being under the control of the elected official who has policy responsibility for the services delivered by that agency.

However, Section 2.3 also compares the structure of the public sector provision of goods and services to that which operates in the private sector. This comparison identifies analogous relationships between a department in the public sector and a firm in the private sector and between a departmental Secretary in the public sector and the manager of a firm in the private sector.

In particular, Section 2.3 investigates where the responsibility for the preparation of departmental financial statements lies in the Australian Commonwealth public sector. The overriding conclusion is that it is the departmental Secretary who has this responsibility.

This finding reinforces the comparison between the Secretary of a department and the manager of a firm when addressing issues of accounting policy choice, and provides justification for applying the theory developed in a private sector context to the accounting policy choices reflected in departmental financial statements.

Therefore, as discussed in Section 2.4, it is the private sector framework, with a focus on the incentives of the departmental Secretary, which is considered most relevant to analyse accounting policy choices in Commonwealth departmental financial statements. It is this approach which is used in Chapter 3 to investigate the decision to adopt accrual reporting.

2.2 The Private Sector

Private sector theory of accounting policy choice proposes that managers choose accounting policies based on the impact that they perceive such choices will have on their personal utility.

Clearly, when attempting to explain why utility maximising agents would choose one accounting policy over another, it becomes necessary to link the utility of the individual to the resulting financial statements. Theorists addressing the private sector have a major advantage over their public sector counterparts in that in most circumstances it is possible to specify an intellectually appealing link between the financial remuneration of individuals and financial statement numbers.

This allows the private sector researcher to focus on the incentives of the manager of a firm to adopt accounting policies which will maximise his own economic rewards. This maximisation is achieved, in part through the minimisation of agency and political costs.

This interpretation is dependent on a further, not unreasonable, assumption that information asymmetry places the manager in a position to gain marginal benefits from his greater knowledge of the operations of the firm.

In recent years, there is also an increasing awareness that an individual's utility is not based solely on economic factors and that social and cultural factors should also be taken into consideration.

The key factors that have been identified as influencing accounting policy choice in the private sector can be classified as:

1. physical costs,
2. agency costs,
3. political costs and political visibility, and
4. social influences.

These matters are discussed in more detail below.

2.2.1 Physical Costs

In applying an utility maximisation approach to accounting policy choice, it is important not to ignore the impact of the cost of the change (Banker, Bunch & Strauss 1989; p. 36, Ingram 1984, p. 130). Changes in accounting and reporting requirements can generally be expected to result in changes to the information production system and, at the least, retraining of financial staff (Watts and Zimmerman 1978, p. 116).

Whether or not the physical cost associated with an accounting policy choice is significant will depend on the specific circumstances.

For example, in investigating the voluntary provision of Value Added Statements, the cost of producing these statements can reasonably be ignored because the statement is

basically a rearrangement of information provided in the other standard accounting statements (Deegan & Hallam 1991, p. 3).

In contrast, the cost of the enforced introduction of current cost accounting could be considered quite significant for those entities which did not already collect information on this basis (Sutton 1988, p. 135).

Increased costs may impact on the firm manager by causing a reduction in the resources available to manage the firm and/or by causing a reduction in the remuneration through salary packages linked to accounting profits, as discussed in more detail in Section 2.2.2.

2.2.2 Agency Costs

Agency costs are a result of the agency relationship between the manager and the owners of the firm. This interpretation is based on a perception of organisations as the result of the interaction of a number of self-interested actors - '*...a nexus for a complex set of contracts (written and unwritten) among disparate individuals.*' (Jensen 1983, p. 326).

These contracting parties include managers, employees, capital providers, suppliers, customers, etc, each party negotiating with the other parties to maximise their own personal utility (Watts & Zimmerman 1990, p. 135).

There are significant costs associated with the contracting process, including the costs of evaluating, negotiating, writing and renegotiating the terms of the contracts, and the costs of monitoring and evaluating performance under those terms (Holthausen & Leftwich 1983, pp. 82-83). These costs are often termed either contract costs (for obvious reasons) or agency costs, because the intent is to bind and motivate the agent to act in the best interests of the principle, rather than those of the agent.

The key resource in all the negotiations is information, but, clearly, this will not be equally available to all the participants. Information asymmetry exists because some contracting parties will be better informed about certain aspects of the environment than others, particularly in relation to their own activities.

The establishment of standard reporting practices, reducing the number of choices available, will reduce the information costs associated with monitoring and negotiating these multitude of contracts (Baber & Sen 1984, p. 93).

The above factors have been integrated to justify the voluntary presentation and independent audit of financial statements in the private sector. It is argued that audited financial statements, prepared using standard accounting practices, provide a cost-beneficial monitoring device. The subsequent reduction of agency costs will increase the relative value of the firm, benefiting the manager, stockholders and creditors. Therefore these contracting parties will all demand the adoption of such practices. This structure underlies the work of a large number of accounting researchers, including Bird (1970), Chow (1982), Mills (1990), Wallace, W.A. (1985) and Watts (1977).

Despite the fact that audited financial statements will help address the problem of information asymmetry, they will not totally negate the impact. If it is accepted that information is not costless, then it will not be economically efficient to collect sufficient information to enforce all contracts perfectly - rational economic agents will only commit resources to becoming better informed when the marginal benefits exceed the marginal costs (Jensen 1983, p. 331).

The manager, who is the most informed about the operations of the firm, is therefore in a position to capitalise on information asymmetries at a marginal level. By focusing on the

incentives of the manager to exploit information asymmetries it becomes possible to develop hypotheses about the subsequent choice of accounting practices.

The two factors which have received the most attention when addressing agency costs are:

1. the impact of management compensation plans, and

2. the existence of debt covenants (Holthausen & Leftwich 1983).

Dealing with management compensation plans first, it was noted that many such plans base some portion of the manager's remuneration on the performance of the firm, as measured through reported accounting numbers, such as rate of return on assets. The purpose of such contracts is to link the manager's remuneration to the performance of the firm to motivate him to act in the best interests of the firm. The side effect of such clauses is that the manager is given an incentive to adopt accounting methods which increase reported performance. If the manager is an economically rational agent, he or she will take such action if the benefit to the manager outweigh the costs. The benefit to the manager will be reduced by the impact that such opportunistic actions will have on future employment opportunities. In addition, the benefit is restricted to a level below the cost to the firm of renegotiating the contract to negate the impact of changes in accounting policies (Christie 1990, p. 33; Holthausen & Leftwich 1983, pp. 84-85[8]).

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[8] Holthausen and Leftwich (1983) provide a review and analysis of nine major studies on the relationship between agency costs and accounting technique choices conducted during 1979 and 1983. Five of these studies addressed the relationship between accounting policy choice and management compensation plans.

Christie (1990) conducted a study which reviewed seventeen research papers, identifying an additional three papers to those covered by Holthausen and Leftwich addressing the relationship between accounting policy choice and management compensation plans.

In a similar manner, accounting numbers may be used in debt covenants to restrict the activities of borrowers and protect the interests of the lender. For example, a loan contract may specify that the borrowing firm bind itself to only issue subsequent debt if certain financial statement ratios, such as net tangible assets to long term debt or earnings to interest charges, are maintained (Watts & Zimmerman 1986, p. 212). Thus, again assuming that renegotiating such contracts is not costless, management will have incentives to choose accounting methods which provide the best slant on these ratios to retain flexibility in structuring balance sheet items. (Ariyo 1988, pp. 89-90; Christie 1990; Holthausen & Leftwich 1983, pp. 86-87; [9] Wong 1988, p. 41).

2.2.3 The Introduction of Political Costs

The above conception of the business environment is one-dimensional. There is an increasing recognition of the fact that no organisation operates in a vacuum - the market system is not unregulated. This leads to consideration of the economic consequences that the political process has on organisations, and of the role that financial statements play in this larger environment.

In simple terms, the set of laws and regulations passed by the Government create political costs, which are defined as:

> wealth re-distributions away from the firm to the government and other sectors of the economy
>
> (Panchapakasen & McKinnon 1992, p. 72).

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[9] Five of the studies analysed by Holthausen and Leftwich (1983) addressed the relationship between accounting policy choice and external debt. Christie (1990) listed an additional twelve studies covering the same topic.

Obvious examples include minimum wage laws, income and sales taxes, and price control over certain commodities. These costs may not only impact on the firm through wealth transfers but also place restrictions on the firm's activities (Panchapakasen & McKinnon 1992, p. 72).

As for the discussion of agency costs, the posited relationships between financial statements and political costs is based on the assumption that accounting numbers are used as a tool to implement wealth transfers, either directly, through specification in legislation such as taxation laws, or indirectly, as a trigger resulting in excessive attention being directed at a particular entity.

The two main foci of research have been through:

1. government regulations, and

2. political visibility (Holthausen & Leftwich 1983).

2.2.3.1 Government Regulation

The impact of government regulations is the easiest relationship to accept and visualise. It has been argued, for example, that in the United States of America (USA) it was the introduction of company taxation on 'net income' which led to the theoretical justification for depreciation as an expense. Prior to the introduction of the legislation the charging of depreciation had been interpreted as a valuation procedure. However, the introduction of the tax created a need to adopt accounting policies which reduced the measure of 'net income' (Watts & Zimmerman 1979).

Providing the costs of monitoring and of changing regulation are significant so that rational regulators will not completely offset each change to accounting procedures, then

firm managers have an incentive to choose accounting procedures which will reduce such wealth transfers away from the firm (Holthausen & Leftwich 1983, pp. 85-86). This manipulation of accounting policies to reduce the impact of current legislation and government control is an *ex post* response to political costs. The second strand, political visibility, addresses *ex ante* management of political costs.

2.2.3.2 Political Visibility

Throughout this dissertation, 'political visibility' is defined as:

> **the relative share of scrutiny by politicians, organised groups such as trade unions, and the general public.**

This is based on the definition provided by Lim & McKinnon (1993, p. 192) that a 'politically visible entity' is:

> ...one which attracts a disproportionate share of scrutiny by politicians, organised groups such as trade unions, and the general public.

The introduction of the concept of political visibility is based on the observation that certain industries, such as the steel industry and the oil industry, appear subject to more political attention than others. This attention can have undesirable consequences, such as increased regulation and investigations into possible market monopolies. (Watts & Zimmerman 1986, pp. 230-231).

Such outcomes will create significant additional costs for firms, including costs to prepare responses and to provide representation at any hearings, the potential for increased taxes, fines or price fixing, and costs to develop information systems to capture any additional information necessary for compliance with increased regulation.

Therefore, political visibility increases the potential for the further imposition of political costs (Panchapakesan & McKinnon 1992, p. 72).

Many studies of political costs and the impact on accounting method choice, have used size, whether based on assets (Hagerman & Zmijewski 1979; Trotman and Bradley 1981; Watts & Zimmerman 1978), profitability measures (Belkaoui & Karpik 1989; Deegan & Hallam 1991; Sutton 1988; Trotman & Bradley 1981) or market capitalisation (Deegan & Carroll 1993; Taylor, Tress & Johnson 1987) as a proxy for political visibility.

The posited relationship between size and political visibility is generally based on anecdotal evidence. A commonly cited example is that of the adverse press received by those large oil companies in the USA which reported record accounting profits during the oil crises of the 1970's (Deegan & Hallam 1991, p. 6; Holthausen & Leftwich 1983, p. 87; Watts & Zimmerman 1986, pp. 230-231). Similar examples are cited in a New Zealand context in Wong (1988, p. 40), whilst Australian examples refer to the activities of the trade unions (Taylor, Tress & Johnson 1987, p. 13) and the higher level of disclosure imposed on large firms by the Corporations Law (Panchapakesan & McKinnon 1992, p. 72).

It is argued that firms will therefore prefer to adopt accounting methods which will reduce their reported size and profitability in an attempt to reduce their political visibility, and thus their exposure to the future imposition of additional political costs.

2.2.4 Integrating Agency Costs and Political Costs in a Social Context

As can be gathered from the above, though not generally represented as such, the political process does not just impose further costs on an organisation but is, in fact, a major determinant of the environment within which organisations and other contracting

parties operate. Government regulations must be considered in the development and structure of a large variety of contracts, such as employment contacts, dealings with customers, bids to take over other organisations, etc.

Thus a complex pattern of relationships and interrelationships exist whereby an organisation, itself the result of competition among various contracting parties, competes with other organisations within its industry sector for customers, labour, supplies, etc, and yet may combine with those same organisations to prevent wealth transfers to other industry segments, and so on.

Obscuring matters further, there is an increasing recognition of the fact that an individual's utility may be based on more than just economic factors, and that rational individuals will also be influenced by their environment and have the ability to influence their environment in return (Burchell, et al 1980, p. 5; Ferris and Haskins 1988; Francis 1990, p. 5; Mangos & Lewis, 1995, p. 56; Thomas 1991, pp. 41-45).

Mangos and Lewis (1995, p. 42) suggest that '*...societal and cultural norms regarding acceptable business practices...limit the range of potential accounting solutions*'. This is consistent with the framework developed by Gibbins, Richardson and Waterhouse (1990), which included consideration of the role of external actors in determining disclosure practices.

Though social pressure cannot, as the sole determining factor, explain accounting policy choice (Guthrie & Parker 1989, p. 351; Mangos & Lewis 1995, p. 53) it does have the potential to add a further dimension.

For example, a study by Neu (1992) found that a model developed to represent the social influences on the manager had greater explanatory power to predict the voluntary production of earnings forecasts, than did a model incorporating only agency and political costs.

This would suggest that there are gains to be made from integrating research into the decision to disclose social information, such as Belkaoui and Karpik (1989), Freedman and Jaggi (1988), Fry and Hock (1976), Gray, Owen and Maunders (1988), Mathews (1984), Tinker, Lehman and Neimark (1991), Trotman and Bradley (1981) and Wokutch and Fahey (1986) with the significant body of research which has found empirical support for a relationship between economic factors and accounting policy choice.

Indeed, the relationship between size and accounting policy choice, as reflected in studies into the impact of political visibility, is reinforced by the social disclosure studies which have found a strong link between the size of an organisation and an increased level of social disclosure (Belkaoui & Karpik 1989; Freedman & Jaggi 1988; Fry & Hock 1976; Trotman & Bradley 1981).

Panchapakesan and McKinnon (1992, pp.74-75), in fact, suggest that increased social disclosure is a measure of an organisation's perception of their political visibility, being one method by which politically visible firms can demonstrate that they are socially responsible, to either establish a favourable image or moderate an already unfavourable one. This approach is similar to that undertaken by Deegan and Carroll (1993) which found evidence to suggest that politically sensitive Australian firms may attempt to win an annual report award as a means of creating a more favourable image.

2.2.5 Developing an Integrated Theory for the Private Sector

Integrating these multiple factors into a model predicting and explaining accounting policy choice is not straightforward.

One problem that must be dealt with is that *'...the incentives provided by the political process (to reduce earnings) are in direct opposition to the incentives provided by management compensation contracts (to increase earnings) with respect to the level of reported earnings'* (Watts & Zimmerman 1986, p. 243; see also Neu 1992, p. 225).

This situation creates a particular problem because it is generally assumed that the basic accounting procedures chosen for external reporting purposes will also be adopted for internal purposes, and vice versa.

There are two alternative justifications for this proposition, both based on the need by management to retain control over the information used to monitor contracts.

The first argument raises the possibility that should an alternative report, providing a different perspective on resource management, be released externally, then those seeking wealth transfers from the firm could choose to use whichever of the reports better furthered their ends. In addition, the suggestion that the financial performance reported was being manipulated could draw increased, undesirable, political attention (Watts & Zimmerman, 1986, pp. 247 -248).

The second argument is based on a need by management to foreshadow assessments of their performance based on the financial statements. Managers will use the same information in their own decision-making processes so that they can predict the outcome of those external assessments (Dirsmith & Lewis 1982, p. 322).

Either way, this 'one set of financial statements' makes it difficult to develop predictions about a manager's choice of accounting policies.

When the preferred alternative is constrained by social influences, the task is further confounded. Mangos and Lewis (1995, p. 40) suggest that this sacrifice of detail and precision is the price that must be paid to develop a richer understanding of these choices.

However, it should be remembered that those studies which have addressed variables in isolation, have produced sound statistical results showing that the predicted relationship between economic variables and accounting policy choices is strong.[10] Thus, though social factors may represent an intervening variable, any influence is likely to be greatest when there is congruence between economic and social arguments, as occurs in relation to the consideration of political visibility.

In summary, private sector theory of accounting policy choice proposes that managers choose accounting policies based on the impact that they perceive such choices will have on their personal utility.

This utility is affected by the use to which the consolidation of those choices, the financial statements, will be put, including:

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[10] See, for example, Christie's (1990) analysis of the statistical validity of published empirical studies into agency and political costs, which indicated that the explanatory power of the size and contracting costs was close to one.

1. the impact that physical costs associated with an accounting policy change may have on the resources at the manager's disposal to manage the firm and also on the personal remuneration of the manager,

2. the impact on potential restrictions on capital restructuring, such as through debt covenants,

3. the impact on regulatory cash flows, such as through taxation, and

4. the impact on the management of social perceptions of their actions (political visibility), to reduce the negative impact of non-conformity with professional and social expectations and/or maximise the benefits to be gained from conformity.

2.3 The Public Sector

Accounting policy choice theory in the public sector has developed from the same basic assumptions outlined in the discussion on the production of financial statements in the private sector.

Though in many such studies the argument is described as being grounded in 'agency theory' (Wallace, W.A. 1987; Zimmerman 1977), 'interest group theory' (Baber & Sen 1984; Carpenter, V.L. 1987), and 'political game perspective' (Lim & McKinnon 1993), it can be stripped down to the same two key propositions:

1. that an individual can be modelled as behaving in an economically rational manner to maximise their own self-interest, and

2. that accounting phenomena can be explained in terms of their ability to address problems arising from information asymmetry. (Banker & Patton 1987, p. 30.)

In addition, both approaches assume that financial statements '*...reflect(s) the agents actions with respect to the disposition of the enterprise resources*' (Baber & Sen 1984, p. 92).

In public sector research, however, it is an elected official that is treated as the agent of the electorate. Public sector financial statements are identified as an accountability document reflecting the performance of the elected official in meeting the demands of the electorate (Banker & Patton 1987, p. 39; Carpenter, V.L. 1991, p. 105; Giroux 1989, p. 204; Zimmerman 1977, p. 124).

This interpretation of events was developed around the municipal government structure of the USA, the two key elements, for the purposes of this argument, being that:

1. voters elect representatives to deliver election policy promises; and

2. such policies are implemented through government agencies under the control of a bureaucrat (Evans & Patton 1988; Giroux 1989; Ingram 1982)[11].

Though it may at first appear reasonable to suggest that the differences between the above arrangement and the private sector structure are fundamental enough to require a

[11] As will be discussed later, this structure closely reflects that which operates in the Australian Commonwealth, though there is one distinction which should be kept in mind. In certain municipalities in the USA, the bureaucrat may be directly elected, rather than appointed by the government. The implications of this relationship would have little relevance in the Australian context.

unique theory to explain and predict accounting policy choice in the public sector, there are also a number of striking similarities.

Table 1 on page 36 was developed to provide answers to a few basic questions. The responses suggest that the parallels between mechanisms for service delivery in the private sector and those in the public sector are as follows:

private sector	*public sector*
firm	government agency
shareholders	government
manager	bureaucrat
customers	electorate

Question	Private Sector	Public Sector
What is the source of demand for services?	customers	electorate
Which actor(s) undertake to meet the demand?	shareholders	government
Which actor(s) are employed to manage delivery of the service?	manager	bureaucrat
What is the primary mechanism for service delivery?	firm	government agency
Who has physical control over financial statement preparation?	firm	government agency
The financial statements represent the activities of the:	firm	government agency
What happens if there is a failure to satisfactorily deliver the services?	buy services from another firm	elect political opponents in next election
Which actor(s) stand to gain through a failure to satisfactorily deliver services?	market competitors	political opponents
Which actors(s) stand to lose through a failure to satisfactorily deliver services?[12]	shareholders & manager	government & bureaucrat

Table 1 - Comparison of the mechanism of service delivery in the private sector to that of the public sector

Applying the private sector framework to this representation would suggest that the bureaucrat is the agent of the government and that the financial statements are an accountability document between the bureaucrat and the government. As noted previously, this is distinctly different from the interpretation that has been adopted in public sector accounting research to date.

[12] Note that customers and the electorate also stand to lose from a failure to satisfactorily deliver services, in the short term. In the private sector this can be addressed through purchasing from another supplier. However, in the public sector, there may be no currently available alternative supplier, eg for social security pensions. This would be equivalent to a monopoly situation in the private sector. Over the longer term, however, it is reasonable to expect the demands of both customers and the electorate to be met.

Apart from the nominal difference in structure, one possible reason as to why this alternative interpretation has not been pursued is that the form of public sector financial statements has, in the past, been quite distinct from that of the private sector.

One of the earliest researchers to address public sector financial reporting, Zimmerman (1977), noted that public sector financial reports were generally prepared on a cash basis, separately identifying each fund operated by the relevant government body, without providing a consolidated result or attempting to eliminate transactions between the funds.

A review by the Organisation for Economic Co-operation and Development (OECD) (1993) of accounting practices adopted by the governments of Australia, Iceland, New Zealand, United Kingdom and the USA, did not find any significant change to this state of affairs. Though a number of countries were developing reforms to either introduce full accrual reports or supplementary accrual information, such reforms had not then been fully implemented.

Cash based reporting on a diversified range of funds makes it difficult to link financial reporting numbers to an individual's utility, other than to propose that a breach of cash restrictions would impact negatively on the responsible actor, perhaps leading to his dismissal.

Only in limited circumstances, such as when a government entity raises funds externally, is it possible to include other incentives to manipulate accounting numbers or to provide increased disclosure, such as to support a government's claim of an ongoing ability to repay debt as it falls due. Pedantically, it is difficult to analyse the impact on the

remuneration of an official resulting from the adoption of a particular inventory costing approach when no inventory costing approach is, in fact, reported.

Thus, the fact that, in general, only a minimal number, if any, generally accepted accounting policies were adopted in public sector financial statements, creates a paucity of accounting policy choices to address.

Zimmerman (1977) dealt with this issue by concentrating on the minimal level of financial disclosure, itself. He suggested two main factors which may have contributed to this state of affairs, being that:

1. the elected official has incentives to minimise the disclosure of financial information, to reduce interference in his actions. For example, a politician arguing for increased resources through taxes would have difficulty in persuading an electorate if a balance sheet was available which clearly indicated a high level of assets; and

2. the average voter can not use public sector financial statements to increase his personal welfare. Therefore, there is little demand for 'better' financial information. However, voters are concerned that there is no abuse of budgetary power and so do demand information about compliance with budgetary restrictions.

These factors underlie the bulk of the research conducted in the public sector.

Baber & Sen (1984) refined Zimmerman's arguments to include the impact of political opponents. They introduced the concept of 'political competition', being the strength of competition expected in future elections, suggesting that the higher the level of political

competition, the greater the demand for 'better' financial information, and the greater the likelihood of adoption of standard reporting practices to reduce information costs.

Other factors affecting the relative power of the elected official which have subsequently been proposed to lead to 'better' reporting practices[13], include:

1. the existence of lobby groups[14], which increases the relative power of small groups of voters (Baber 1990; Carpenter, V.L. 1991; Giroux 1989),

2. the existence of external debt-holders, increasing the demand for information on debt paying ability (Baber & Sen 1984; Carpenter, V.L. 1991; Evans & Patton 1988; Feroz & Wilson 1992; Ingram 1984; Ingram & DeJong 1987), and

3. the existence of an appointed rather than elected bureaucrat, placing additional pressures on the elected official to monitor the performance of the bureaucrat as the official would now be held responsible for the bureaucrat's actions (Giroux 1989; Ingram 1984; Zimmerman 1977).

The last-mentioned studies are some of the few which have included consideration of the bureaucrat's incentives. However, as noted, the arguments are framed in terms of the impact on the elected official. The demand by the politician for better information is considered sufficient to override the bureaucrat's incentives to disclose as little

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[13] It is interesting to note that that the 'better' standard reporting practices referred to require cash based reporting of expenditures and receipts of funds, though supplemented by additional notes, including some accrual information.

[14] This is generally treated as a subset of 'political competition'.

information as possible so as to be in a better position to bargain with the elected official for increased resources.

There is nothing in this line of argument, however, to suggest that an alternative focus on the incentives of the bureaucrat is less valid than the above approach. In fact, the analysis of the Australian environment in Section 2.3.1, provides sound reasons as to why, in an Australian context at least, the focus should be on the bureaucrat (the departmental Secretary) when addressing public sector accounting policy choice.

It is worth noting that though the following description is specific to the Australian Commonwealth public sector, there are distinct parallels between this structure and that which exists in the municipal context in the USA.

Indeed, Lim and McKinnon (1993, p. 193) considered the similarities between the American and the Australian structures to be so striking that they did not question the applicability of a USA framework to the Australian environment.

2.3.1 The Structure and Accountability of the Commonwealth Public Sector

In simple terms, voters elect representatives to form the Commonwealth Parliament. Party alliances within the elected Parliament determine the government. It is generally accepted that voters choose their representatives based on both the candidate's own position and the programmes and policies of the political party he/she represents. It is implicitly understood that the political party, or parties, which form the government, will initiate and implement actions to fulfil its election promises (Jaensch 1992, pp. 86-87).

The government creates departments to provide policy advice and implement policy decisions. Departments are thus the mechanism by which the elected government fulfils its obligations to the electorate (Jaensch 1992, p. 273).

Departments are controlled by a permanent head, the departmental Secretary, who is, in turn, responsible to a Minister of Parliament (Jaensch 1992, p. 273). The Ministers are appointed by the government (not the Parliament) and collectively form the Cabinet. In effect, the Cabinet controls Parliament, rather than the other way around (Jaensch 1992, p. 248).

Though the Minister is responsible to the elected Parliament for his own actions and the actions of his department (Jaensch 1992, p. 251), it is the departmental Secretary who has immediate responsibility for the administration and management of the department.

In particular, the departmental Secretary is responsible for the proper financial management of his department (DoF 1992a, p. 40). This occurs through the operation of section 25 of the *Public Service Act 1922*, which states:

> The Secretary of a Department shall, under the Minister, be responsible for its general working, and for all the business thereof, and shall advise the Minister in all matters relating to the Department.

Further, section 2AB of the *Audit Act 190* states:

> The Secretary of a Department is responsible for making appropriate arrangements for implementing the provisions of this Act, the regulations and any directions given under this Act or under the regulations in relation to the Department.

The Secretary of a department also has the responsibility to prepare the financial statements under section 50(1) of the *Audit Act 1901,* which states:

> As soon as practicable after the end of each financial year, the Secretary of each Department shall prepare and (except where the Secretary is the Auditor-General) submit to the Auditor-General a financial statement for the Department in respect of the financial year.

The departmental annual report, which incorporates the financial statements, is clearly identified as a tool to allow the departmental Secretary to discharge his accountability obligations, where accountability is defined as:

> ...existing where there is a direct authority relationship within which one party accounts to a person or body for the performance of tasks or functions conferred, or able to be conferred, by that person or body.
>
> (Management Advisory Board and its Management Improvement Advisory Committee (MAB-MIAC) 1991, p.1).

The concept of accountability is also linked to assessments of performance. MAB-MIAC (1991, p.1) stated:

> It [accountability] also implies delegation of responsibility and authority, an essential element of which is that the delegator does not lose responsibility for performance and, therefore, depending on the circumstances, may be called to account.

The link between the annual report, which incorporates departmental financial statements, accountability and assessments of performance is further evidenced in the statement by the House of Representatives Standing Committee on Finance and Public Administration (1990, p. 100) that the annual report is an:

> ...important accountability document ... prepared by the head of each Department or agency to the relevant Minister on the operation or administration of government programs...

Similarly, MAB-MIAC (1991, p. 7) stated:

> Public servants have several avenues available for reporting on their performance and accounting for the appropriate discharge of their duties. Key external documents include annual reports and annual financial statements...

Finally, accounting standard setters in Australia share this view, whereby for the purposes of reporting, each department is to be treated as a 'reporting entity', consistent with the principles of Statement of Accounting Concepts 1 (AARF 1993, paras. 17-23). Each reporting entity is required to prepare general purpose financial reports, the objectives of which are to:

> ...enable managements and governing bodies to discharge their accountability. Managements and governing bodies are accountable to those who provide resources to the entity for planning and controlling the operations of the entity.
>
> (AARF 1990b, para. 14)

Though the accounting standard setters employ a slightly different definition of 'accountability' to that developed by MAB-MIAC and quoted above, the meaning is the same. The AARF definition of accountability as:

> ...the responsibility to provide information to enable users to make informed judgements about the performance, financial position, financing and investing, and compliance of the reporting entity...
>
> (AARF 1990b, para. 5)

also incorporates a clear link between accountability and performance.

Within this framework, Parliament is identified as the primary user of the departmental financial statements (AARF 1993, para. 21), ie. **departmental financial statements are not intended to reflect the performance of Parliament to the electorate, but of the departmental Secretary to the Parliament.**

The above discussion is summarised in Figure 2, below. The 'line of control' incorporated in the diagram reflects the accountability framework developed by MAB-MIAC (1991)[15].

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[15] MAB-MIAC, however, treat the parliament, government and cabinet as one.

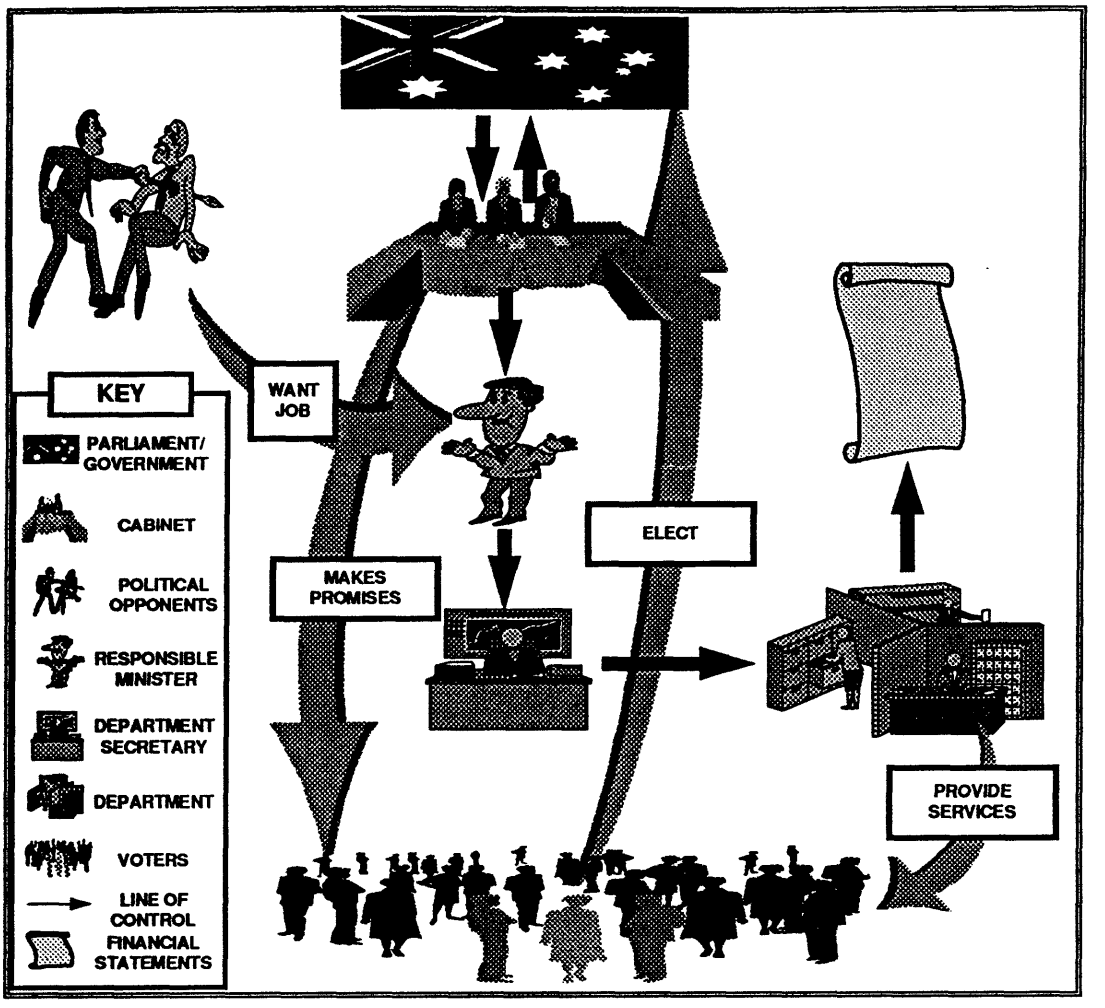

Figure 2 - Accountability in the Commonwealth Public Sector

It is fairly clear that in Australia the departmental financial statements are a mechanism by which the departmental Secretary accounts for his performance in the management of resources provided to him.

This would suggest that to analyse accounting policy choice in departmental financial statements in Australia the focus should be on the incentives of the departmental Secretary.

2.4 Which Framework should be Adopted in an Australian Environment?

The question therefore remains as to what obstacles exist to prevent or discourage the adoption of such an approach. In response, it is notable that in the empirical research conducted to date, there is little to suggest that the focus suggested above is not valid.

Though it has been suggested that the public sector requires a unique theory (Baber 1990, p. 58), when addressing that element which has been identified as clearly distinguishing the public sector environment, being that '*...unlike their private sector counterparts, elected officials face competitive elections at regular intervals*', the results have been rather lacklustre.

Though two studies which used economic modelling to support their arguments provided theoretical proof (Baber 1990[16]; Banker & Patton 1987[17]) in empirical studies a positive correlation between quality of financial reports and 'political competition' has been noticeably lacking.

Out of five empirical studies which addressed this issue (Baber & Sen 1984; Carpenter, V.L. 1991; Evans & Patton 1988; Giroux 1989; Ingram 1984), only one (Ingram 1984) provided reasonable support.

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[16] Baber (1990) used economic modelling to argue that politicians face incentives to report high quality audited financial information when they face a high level of political competition (ie the incumbent is not assured of an 'easy win' in the next election), even when their constituents do not demand such information, but are less likely to provide such information when political competition was low.

[17] Banker and Patton (1987) used economic modelling to confirm that given the low level of direct benefits to voters, much greater weight would be placed on compliance measures than on financial performance, or output, measures.

Given that this pressure has been proposed as one of the most direct on the elected official to improve financial reporting, these results are disappointing and should raise questions about the assumptions underlying the argument.

In contrast, those factors which have been found to have a positive relationship with 'better' financial reporting, particularly:

1. an appointed rather than elected bureaucrat (Giroux 1989; Ingram 1984; Zimmerman 1977), and

2. the existence of external debt finance[18] (Baber & Sen 1984; Carpenter, V.L. 1991; Evans & Patton 1988; Ingram 1984; Ingram & DeJong 1987),

are equally consistent, if not more so, with a focus on the incentives of the bureaucrat, rather than the elected official.

In fact, even though claiming to apply Giroux's 1989 framework for public sector accounting policy choice to the Australian environment, Lim and McKinnon (1993, p. 190) actually adopted a focus on the incentives of the bureaucrat, but restricted the application to '*...those entities which bear most resemblance to their private sector counterparts*'.

For the reasons outlined above, this latter restriction appears extraneous, and a focus on the incentives of the bureaucrat is applicable to most public sector entities in the Australian environment.

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[18] Ingram(1984) and Ingram & DeJong (1987) actually considered State or Federal aid, rather than debt finance, per se, but the characteristics of the two as far as the need to justify the financial management skills of the debtor, are the same.

2.5 Summary

This chapter has outlined accounting policy choice theory in the private sector and in the public sector.

Theory in the private sector focuses on the incentives of the manager to select accounting policies based on the impact that such choices will have on his personal utility. The financial statements are viewed as primarily reflecting the performance of the firm, and a link is developed between the utility of the manager and accounting policy choices, through consideration of such matters as management compensation plans, debt covenants, imposition of taxes, political visibility, and other social factors.

In contrast, theory in the public sector focuses on the incentives of elected officials to require bureaucrats to adopt certain accounting practices to maximise the elected official's personal utility. The financial statements are viewed primarily as providing feedback to the electorate on the performance of the elected official to fulfil election promises. There are few links developed for the use of the financial statement numbers, except to prove compliance with approved expenditure limits and, where relevant, to be used to support applications for the raising of loan capital.[19]

However, Section 2.3 suggests a parallel between the role of a Commonwealth departmental Secretary and the role of the manager of a firm. In addition, the view of departmental financial statements as reflecting the performance of the departmental

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[19] Note that the form of public sector financial statements may have contributed to this divergent approach as there was no equivalent to a 'bottom line' which could be manipulated through alternative depreciation rates, inventory approaches, etc. The adoption of full accrual reporting will change this, and there is potential for much greater application of private sector theories to public sector reports in the future.

Secretary in managing the department is closely aligned to the interpretation of the financial statements of a firm as reflecting the performance of the firm manager in managing that firm.

This analysis provides sound reasons to conclude that, in Australia at least, the analysis of the influence of utility maximisation incentives on accounting policy choice by managers in the private sector has high potential for applicability to appointed bureaucrats in the public sector.

The similarities identified indicate that to apply utility maximisation arguments to the public sector environment does not necessarily '*...require a theory that considers the characteristics that distinguish political markets from other economic markets*' (Baber 1990, p. 57).

Indeed, Schedule 1 to this chapter, provides evidence that an analysis of the incentives of the elected officials would not prove useful when addressing the early adoption of accrual reporting by Commonwealth government departments.

For these reasons, this research study will apply the framework outlined in Section 2.2 to explain and predict accounting policy choice in the private sector, to the accounting policy choices of Commonwealth departmental Secretaries.

Schedule 1 - Early Adoption of Accrual Reporting by Commonwealth Departments

In addressing the early adoption of accrual reporting by Commonwealth Departments, a focus on the incentives of the elected official would suggest that all Departments responsible to the same Minister would adopt the same reporting practices.

However, a brief review of Table 2 on the following page, indicates that this was not the case during the two years prior to mandatory adoption of accrual reporting.

This table groups agencies by Ministerial portfolio as indicated in Budget Paper No. 2 (Commonwealth of Australia 1992, Commonwealth of Australia 1993).

Those agencies which are shown in bold italic type, and asterisked, reported on an accrual basis for the indicated financial period, whilst the other agencies continued to report on a modified cash basis. This latter information was identified from a listing provided by the Department of Finance.

It is fairly clear that consistent practices were not adopted across portfolios and so any analysis based on the responsible Minister's incentives is unlikely to prove fruitful.

Ministerial Portfolio Grouping - 92-93	Ministerial Portfolio Grouping - 93-94
Senate	***Senate****
House of Representatives	House of Representatives
Parliamentary Reporting Staff*	***Parliamentary Reporting Staff****
Parliamentary Library	***Parliamentary Library****
Joint House	***Joint House****
Arts and Administrative Services Australian Electoral Commission	Administrative Services Australian Electoral Commission
Attorney-General's* Administrative Appeals Tribunal Australian Federal Police Australian Security Intelligence Organisation Family Court of Australia Federal Court of Australia Human Rights and Equal Opportunity Commission National Crime Authority Office of the Director of Public Prosecutions Office of Parliamentary Counsel	***Attorney-General's**** Administrative Appeals Tribunal Australian Federal Police ***Australian Security Intelligence Organisation**** Family Court of Australia ***Federal Court of Australia**** Human Rights and Equal Opportunity Commission National Crime Authority National Native Title Tribunal ***Office of the Director of Public Prosecutions**** Office of Parliamentary Counsel
	Communication and the Arts
Defence	Defence
Employment, Education and Training	Employment, Education and Training
Environment, Sport and Territories Office of the Supervising Scientist for the Alligator Rivers Region	Environment, Sport and Territories
Finance* ***Australian National Audit Office**** Retirement Benefits Office	***Finance**** ***Australian National Audit Office**** Commonwealth Superannuation Administration
Foreign Affairs and Trade Australian Secret Intelligence Service	***Foreign Affairs and Trade**** Australian Secret Intelligence Service
Health, Housing, Local Government and Community Services ***National Capital Planning Authority**** Veteran's Affairs	Housing and Regional Development ***National Capital Planning Authority****
	Human Services and Health
Immigration and Ethnic Affairs	Immigration and Ethnic Affairs
Industrial Relations Affirmative Action Agency Australian Industrial Registry	Industrial Relations Affirmative Action Agency Australian Industrial Registry
Industry Technology and Regional Development Australian Customs Service Automotive Industry Authority Textiles, Clothing and Footwear Development Authority	Industry Science and Technology Australian Customs Service Automotive Industry Authority Textiles, Clothing and Footwear Development Authority
Primary Industries and Energy	***Primary Industries and Energy****
Prime Minister and Cabinet ***Australian Science and Technology Council**** ***Commonwealth Ombudsman**** ***Merit Protection and Review Agency**** Office of the Inspector-General of Intelligence and Security Office of National Assessments Public Service Commission	***Prime Minister and Cabinet**** ***Australian Science and Technology Council**** ***Commonwealth Ombudsman**** ***Merit Protection and Review Agency**** Office of the Inspector-General of Intelligence and Security ***Office of National Assessments**** Public Service Commission
Social Security	***Social Security****
Tourism*	***Tourism****
Transport and Communications	Transport Spectrum Management Agency
Treasury Australian Bureau of Statistics Australian Taxation Office ***Industry Commission**** Insurance and Superannuation Commission Prices Surveillance Authority Trade Practices Commission	***Treasury**** ***Australian Bureau of Statistics**** Australian Taxation Office ***Industry Commission**** ***Insurance and Superannuation Commission**** ***Prices Surveillance Authority**** Trade Practices Commission
	Veterans' Affairs*

Table 2 - Departments grouped by Ministerial Portfolio in 1992-93 and 1993- 94
(those reporting on an accrual basis indicated in bold and asterisked)