# Chapter 1 Introduction

## Background

1.1 The annual accounts of the Government of the Hong Kong Special Administrative Region (HKSAR) are prepared by the Director of Accounting Services and audited by the Director of Audit pursuant to the relevant provisions primarily laid down in the Public Finance Ordinance (PFO) (Cap. 2) and the Audit Ordinance (Cap. 122).

1.2 The presentation of the annual accounts of the Government has evolved over many years partly to meet the statutory reporting requirements and partly to present a more comprehensive picture of the Government's financial position and financial performance for a year. The development has been based on a series of ad hoc decisions over the years and the Director of Accounting Services believes that the current presentation is unsatisfactory as significant assets and liabilities are omitted from the accounts and the accounting policies are anomalous in certain aspects.

1.3 The accounts currently submitted under the Audit Ordinance are prepared mainly on a cash basis of accounting which recognises transactions as revenue or expenditure of a fiscal year when cash is received or paid. The difference between revenue and expenditure is the surplus or deficit for the year. The accounts, however, are not on a pure cash basis as some of these transactions are not treated as revenue or expenditure for the year, but are shown as assets or liabilities in the Statements of Assets and Liabilities at the end of the year.

1.4 All jurisdictions throughout the world used to maintain their books of account and present their annual financial reports on a cash basis. Budgets, or appropriations, were on the same basis, and control was simple. In the HKSAR Government, that basis exists now – Controlling Officers are required to ensure that cash expenditure does not exceed cash budgets. The Government's fiscal surplus is the excess of revenue over expenditure, and the fiscal reserve comprises mainly cash and bank balances and investments with the Exchange Fund.

1.5 In recent years, some developed countries have moved towards the accrual basis of accounting, the main intentions of which are –

(a) to present fairly the financial performance of the government by recognising revenue and expenditure when transactions occur in the Statement of Financial Performance;

(b) to present fairly the financial position of the government by the inclusion of all material assets and liabilities in the Statement of Financial Position; and

(c) to demonstrate the accountability for resources employed by the government by the inclusion of material assets in the Statement of Financial Position or in the Stewardship Statement[1].

Recognising these changes, the International Federation of Accountants (IFAC) has been attempting to develop and set accounting standards which aim to improve the quality of financial reporting in the public sector around the world.

1.6 From time to time since the early 1990s, some Legislative Council (LegCo) Members have suggested the use of accrual accounting by the Government.

1.7 In the light of the above, a Task Force was set up in April 1999 to review the HKSAR Government's financial reporting. In October 1999, during the course of the Task Force deliberations, the Director of Audit made known his observations and recommendations concerning the financial reporting of the Government in his Value For Money Report No.33. He has mainly recommended that the Task Force should fully take into account the inadequacies of the cash-based financial reporting of the Government and the benefits of accrual accounting, and that a definite timetable of implementation should be drawn up if accrual accounting is to be adopted. The Public Accounts Committee of the LegCo was informed that in order to solicit views from concerned parties on the review of government financial reporting, the Director of Accounting Services had organised a symposium on 7 March 2000. The Task Force has already taken into account the views expressed during the symposium and the Director of Audit's comments in formulating its recommendations.

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

1.8 The Task Force is chaired by the Secretary for the Treasury and comprises representatives of the Finance Bureau and the Treasury. The composition is at Annex 1 and its terms of reference are –

(a) to examine the background to the current standards of financial reporting of the Government of the HKSAR;

[1] A Stewardship Statement provides narrative details of major physical assets with which the government has been entrusted.

(b) to 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;

(c) to 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 would have an impact on the current budgetary process; and

(d) to 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.

## Review Approach

1.9 In carrying out the review, the approach taken by the Task Force was to first examine the existing financial reporting practices and their backgrounds including the statutory and budgetary frameworks leading to the development of the Government Accounts to their current states. The strengths and deficiencies of the accounts were then assessed against the financial reporting objectives identified by the Task Force. In identifying ways to address the deficiencies, the Task Force made reference to the financial reporting practices and developments in a number of developed countries and the requirements of generally accepted accounting principles (gaaps) including the pronouncements and publications of leading local and international accountancy bodies such as the Hong Kong Society of Accountants (HKSA), IFAC and International Accounting Standards Committee (IASC). The costs and benefits of various reporting practices were evaluated having regard to the circumstances of the HKSAR Government. In drawing up its recommendations and implementation plan, the Task Force has also taken into account the recommendations of the Director of Audit, the Public Accounts Committee of the LegCo and the views obtained from the community and the accounting profession through consultation.

# Chapter 2 Current Financial Reporting of HKSAR Government

## Financial Activities of the Government

2.1 For control and funding purposes, the financial activities of the HKSAR Government are undertaken through a number of accounts and funds. The General Revenue Account (GRA) acts as the central funding device with resources being transferred as necessary to funds established to finance specific activities.

2.2 Under section 29 of the PFO, the LegCo may by resolution provide for the establishment of funds to finance specific activities. Eight Funds, as set out below, have been established accordingly and their respective purposes are given in Annex 2. They are included, together with the GRA, in the Government's Annual Estimates, and appropriations are approved each year to meet their anticipated cash expenditure requirements.

(a) Capital Works Reserve Fund (CWRF)

(b) Capital Investment Fund (CIF)

(c) Civil Service Pension Reserve Fund (CSPRF)

(d) Disaster Relief Fund (DRF)

(e) Innovation and Technology Fund (ITF)

(f) Land Fund

(g) Loan Fund

(h) Lotteries Fund

## Statutory Reporting Requirements

2.3 Under the Audit Ordinance, the Director of Accounting Services is required to send to the Director of Audit each year a **statement of the assets and liabilities** and a **statement of the receipts and payments** in respect of the GRA and each of the Funds listed in paragraph 2.2 above except the Lotteries Fund. Section 12 of the same Ordinance also provides for the laying of the audited financial statements before the LegCo. The statements of receipts and payments are, under the accounting convention, produced to reflect cash received and paid during the reporting period. The requirements stipulated in the Audit Ordinance have therefore led to the current practice of recording both revenue and expenditure of the Government on the cash basis.

2.4 The Lotteries Fund is reported and audited separately pursuant to section 7 of the Government Lotteries Ordinance (Cap. 334). The reporting requirements and arrangements are similar to those of the other seven Funds.

## Current Objectives and Basis of Accounting

2.5 The payments which the Government is permitted to make in any financial year are limited to the amounts approved by the LegCo under the PFO and the Appropriation Ordinance. In approving the estimates of expenditure, the LegCo also approves the purposes (as defined by the ambit of each Head and Subhead[2]) for which payments can be made.

2.6 The accounts submitted under the Audit Ordinance are prepared mainly on a cash basis. The cash-based accounts serve both to demonstrate that moneys have been paid within the limits and ambits approved by the legislature and to satisfy the statutory requirements for the production of statements of receipts and payments.

2.7 The cash-based accounts are modified (as will be explained in paragraph 2.11.1(c) below) in the case of the CIF and the Loan Fund to include the values of their assets (namely investments under the CIF and loans outstanding under both the CIF and the Loan Fund) in their respective accounts.

## Existing Annual Accounts of HKSAR Government

2.8 The annual accounts of the HKSAR Government now, in accordance with the aforesaid legal requirements, consist of a Statement of Assets and Liabilities and a Statement of Receipts and Payments for the GRA and each of the Funds established under section 29 of the PFO.

[2] For GRA expenditure, a Head usually corresponds to a government department or bureau. A Subhead generally reflects subjective (i.e. type of expense) analysis of expenditure within a Head, e.g. "Salaries" and "General Departmental Expenses".

2.9 In addition, the annual accounts include a Consolidated Account which presents the combined picture of the GRA and all the Funds except the Lotteries Fund. The Consolidated Account aims to give an overview showing the overall position of cash resources available. It excludes inter-fund transfers as well as the transactions and balances of the Lotteries Fund because the revenue of that Fund, mostly derived from the operation of the Mark Six Lotteries, was considered as being earmarked for social welfare services and could not be used for general government purposes. The Consolidated Account is not statutorily required and is therefore not audited by the Director of Audit.

2.10 Supporting statements showing detailed analyses of Revenue and Expenditure for the GRA and the relevant Funds, variance analyses and components of the investments acquired and the loans made are also published together with the annual accounts.

2.11 The main features and components of the existing sets of financial statements are described in the following paragraphs.

2.11.1 Statements of Assets and Liabilities

(a) A summary of the Statements of Assets and Liabilities included in the annual accounts of HKSAR Government is at Annex 3-1, from which it can be seen that the accounts are not on a pure cash basis of accounting since some assets and liabilities (but not all) are included in the Statements.

(b) The types of **Assets** currently reported in the Statements of Assets and Liabilities are –

- Investments with the Exchange Fund – investments and deposits placed with the Exchange Fund
- Deposits with banks – Hong Kong dollar and foreign currency deposits placed with licensed banks in Hong Kong
- Cash and bank balances – cash in hand, in transit, with banks and agents, and imprest accounts
- Advances – moneys paid out (e.g. payments for the West Rail project to be reimbursed by the Kowloon-Canton Railway Corporation (KCRC)) under section 20 of the PFO, which are either recoverable or chargeable to expenditure upon appropriate authority being given

- Suspense Accounts – established under section 30 of the PFO, the balance of which mainly represents the cost of stocks in hand (e.g. stocks held with Government Supplies Department)

- Investments – equity holdings (e.g. in the MTR Corporation Ltd. (MTRCL) and Airport Authority) and other capital investments (e.g. in Hong Kong Housing Authority (HKHA)) which are recognised at cost or original valuation as assets in the CIF but are excluded from the Consolidated Account

- Loans outstanding – housing, education and other loans which are, similar to the above accounting treatment for investments, recognised as assets in the CIF and the Loan Fund but are excluded from the Consolidated Account

(c) The Statements of Assets and Liabilities of the CIF and the Loan Fund are structured to show the overall financial position of the Funds including the investments acquired and total outstanding loans. On the other hand, the Consolidated Account aims to show the overall position of cash resources available. Accordingly, the investments and outstanding loans held under the CIF and the Loan Fund are excluded from the Consolidated Account but are disclosed at cost or original valuation in the Notes on the Accounts.

(d) The types of **Liabilities** currently reported in the Statements are –

- Deposits – moneys received (e.g. tax reserve certificates and water deposits) under sections 23 and 24 of the PFO and moneys withheld as contract retentions, which are in due course either repayable or transferable to General Revenue

- Suspense Accounts – established under section 30 of the PFO, the balances of which represent (i) the unutilised balance of net proceeds arising from issuing and dealing with special and commemorative coins; and (ii) the net amount arising from dealing with the regrant or renewal of government leases and managing the properties comprised therein.

(e) The **Fund Balance** represents the excess of the reported Assets over the Liabilities. In the case of the CIF and the Loan Fund, the Fund Balance is divided into two parts –

- Applied Fund – represents the sum of investments acquired and the outstanding loans made from the Funds

- Available Fund – represents funds available for acquiring investments or making loans for the purposes of the Funds

(f) The **Consolidated Fund Balance** comprises (i) the Fund Balances of the GRA, CWRF, CSPRF, DRF, ITF and Land Fund; and (ii) the Available Fund Balances of the CIF and Loan Fund.

2.11.2 Statements of Receipts and Payments

(a) A summary of the Statements of Receipts and Payments included in the annual accounts of HKSAR Government is at Annex 3-2.

(b) The major types of **Revenue** currently reported in the Statements of Receipts and Payments are –

General Revenue Account (GRA)

- Taxes, rates and duties
- Property and investment income
- Repayments of loans, reimbursements, contributions and other receipts (including transfers from other Funds, if any)
- Utilities, fees and charges

Capital Works Reserve Fund (CWRF)

- Land premium
- Investment income
- Proceeds from government borrowing, if any

Capital Investment Fund (CIF) and Loan Fund

- Income/interest on investments/loans
- Repayments of loans
- Proceeds from sale of investments, if any
- Appropriations from General Revenue, if any

(c) The major types of **Expenditure** currently reported are –

General Revenue Account (GRA)

- Heads of Expenditure – represent cash expenditure (comprising both recurrent and non-recurrent expenditure) in respect of –
  - Personnel expenses, departmental expenses, other charges and expenditure under the Capital Account incurred by government departments and bureaux
  - Subventions paid to the subvented sector and non-departmental public bodies (e.g. Hospital Authority and Vocational Training Council (VTC))
  - Transfers to Funds established under section 29 of the PFO

Capital Works Reserve Fund (CWRF)

- Public Works Programme – land acquisition, port and airport development, buildings, drainage, civil engineering, highways, new towns and urban area development, waterworks and housing
- Capital subventions, major systems and equipment and computerisation
- Transfer to General Revenue, if any
- Repayments of government borrowing, if any

Capital Investment Fund (CIF) and Loan Fund

- Acquisition of investments
- Loan payments

2.11.3 Notes on the Accounts

In addition to the supporting analyses for individual items shown on the face of the Statements of Assets and Liabilities and Statements of Receipts and Payments, major items disclosed in the Notes on the Accounts include –

- Purpose and the relevant legislation
- Accounting policies

- Assets and liabilities which are not included in the Statements of Assets and Liabilities (e.g. loans to government officers on training scholarships and outstanding promissory notes issued to the Asian Development Bank in respect of contributions to the Asian Development Fund)
- Contingent liabilities (e.g. litigation and guarantees provided)

2.11.4 Supporting Statements and Variance Analyses

The following supporting statements and variance analyses are published together with the annual accounts –

*Supporting Statements*

- GRA – Statement of Revenue Analysis by Head
- GRA – Statements of Expenditure Analysis (by Head and Subhead and by Head and Component)
- CWRF – Statements of Project Payments (Summary and Analysis by Head)
- ITF – Statement of Grants

The above statements compare the actual revenue or expenditure for a year with the estimates.

- CIF and Loan Fund – Statements of Investments and Loans
- GRA – Losses of Cash and Valuables due to Theft, Fraud or Negligence

*Variance Analyses*

- Variance analyses by GRA Revenue and Expenditure Head

Significant variances (exceeding 10%) between the actual revenue/ expenditure and the estimates are explained.

**Monthly and Quarterly Reporting of Financial Results and Position**

2.12 The HKSAR Government has been releasing a monthly summary of its financial results in accordance with the International Monetary Fund's

Special Data Dissemination Standard. The monthly financial results are prepared on the cash basis to report on the consolidated revenue, expenditure, surplus/deficit and balance of the fiscal reserves of the Government both for the month and for the year up to the month being reported.

2.13 At quarterly intervals, a Consolidated Statement of Assets and Liabilities and a Consolidated Statement of Receipts and Payments are also published in the Government Gazette to report on the financial positions and results of the Government for the quarter and for the year up to the quarter being reported. Similar to the published monthly financial results, these Statements are prepared on the cash basis.

## Financial Statements of Trading Funds and Government Utilities

2.14 In addition to the annual accounts produced by the Director of Accounting Services, the Government publishes accrual-based financial statements for services which are commercial in nature, namely Trading Funds and Government Utilities. The financial statements aim to present fairly the financial performance and position of each Trading Fund and Government Utility.

(a) <u>Trading Funds</u>

Trading Funds are financial and accounting entities established by resolution of the LegCo under the Trading Funds Ordinance (Cap. 430). Each Trading Fund is set up for the provision of a specific service or a group of government services, and it operates on a quasi-commercial basis and is self-financing, i.e. it is not included in the Government's Annual Estimates but is required to fund itself from the income generated from its services whether those services are provided to government departments or to the general public.

The annual accounts of Trading Funds are prepared in accordance with gaaps promulgated in various Accounting Standards issued by professional accounting bodies. Pursuant to the requirements laid down in the Trading Funds Ordinance, their financial statements are audited by the Director of Audit and tabled in the LegCo. The Trading Funds in operation at present are the Land Registry, Companies Registry, Office of the Telecommunications Authority, Post Office, and Electrical and Mechanical Services Trading Fund.

(b) <u>Government Utilities</u>

Although not required statutorily, Operating Accounts of Government Utilities are produced annually. The Operating Accounts provide an overall picture of the financial performance and position of each utility undertaking, enable comparisons to be made with past performance and targets, and provide a basis on which decisions can be made for future planning.

The unaudited financial statements are prepared on the accrual basis and are considered by the respective Operating Accounts Committee chaired by the Secretary for the Treasury. In general, the purpose of the Committee is to examine the Operating Accounts, to analyse performance, to consider changes in specific pricing policy taking into account the overall planning policy, and to set the desired rate of return on capital invested.

The existing Government Utilities are the Government Toll-Tunnels, Lantau Link, Marine Ferry Terminals, Sewage Services and Water Authority.

**Activities outside the Government**

2.15 Apart from activities undertaken by the Government (i.e. government departments and bureaux), the Government is also financially involved in other modes of public service delivery in the form of –

(a) Investments in public corporations: equity holdings in such corporations as the MTRCL, KCRC and Airport Authority which operate on commercial principles and are managed independently;

(b) Other funds (i.e. other than those set up under section 29 of the PFO): funds created for meeting specified government purposes (e.g. Quality Education Fund) and for whose use the Government is ultimately answerable;

(c) Statutory bodies established to carry out specific objectives and functions (e.g. implementing public housing programmes by the HKHA and achieving monetary policy objectives by the Hong Kong Monetary Authority (HKMA)), in which the Government has an ownership interest in their net assets/surplus funds as provided in the relevant statutes; and

(d) Recurrent and capital subventions provided to the subvented sector (e.g. education and social welfare) and non-departmental public bodies (e.g. Hospital Authority and VTC).

2.16 For the above activities undertaken outside the Government, separate financial statements are produced by the entities concerned and in most cases, the statements are prepared on the accrual basis.

# Chapter 3 Review of Current Financial Reporting Policies

## Objectives of Government Financial Reporting

3.1 Government financial reporting aims to provide information to meet the needs of users of the financial statements. The principal users include LegCo Members, the general public, investors and analysts. Whilst different groups of users have their own specific focuses and requirements, there are also common information needs.

3.2 The Task Force considers that the major objectives of government financial reporting are –

(a) <u>Budget Compliance/Stewardship</u>

The financial statements should demonstrate the Government's compliance with budget appropriations approved by the legislature and the stewardship of cash spending.

(b) <u>Financial Performance</u>

Information should be provided to report on the spending of public moneys (e.g. resources allocated to different areas, nature of expenditure and cost of services delivery), how the spending has been financed and whether the revenue collected is sufficient to finance the Government's expenditure.

(c) <u>Financial Position</u>

The financial statements should report fairly on the assets and liabilities of the Government and its reserves.

(d) <u>Informed Decision Making</u>

Information should be provided to induce informed decision making, evaluation and planning and to enhance cost-control and cost-effectiveness.

(e) <u>Accountability for Resources Employed</u>

Information should be provided to demonstrate the Government's accountability for resources employed in the delivery of public services shown either as assets in the Statement of Financial Position or as non-financial information in the Stewardship Statement.

## Strengths and Deficiencies of Current Financial Reporting

3.3 Having regard to the above stated reporting objectives, the Task Force has assessed the adequacy of the current financial reporting policies and practices of the HKSAR Government, and the identified strengths and deficiencies are set out in the following paragraphs.

3.3.1 The major strengths of the current financial reporting policies are –

(a) The expenditure is currently reported on the cash basis and shown by Head and Subhead as against the relevant approved estimates for the year in the annual accounts of the Government. This provides information to show that Government spending has been made in accordance with the purposes (as defined by the ambit of each Head and Subhead) and the limits approved by the legislature for the year pursuant to the PFO and the Appropriation Ordinance.

(b) The cash-based financial statements show the sources and disposition of cash resources. They show the cash required to finance the activities of the Government, the cash raised to meet those requirements, and the cash resources available. The principles underlying the cash basis of accounting are simple to understand and operate, and are considered to be more objective (as compared with the accrual basis) since there is no need to exercise subjective judgement or to arrive at estimation, for instance, on the valuation of other assets and liabilities to be included in the financial statements.

(c) The form and content of the financial statements comply with the requirements laid down in the Audit Ordinance or the Government Lotteries Ordinance in the case of Lotteries Fund. In addition to these statutory requirements for the GRA and individual Funds, a Consolidated Account is produced to present the combined picture of the GRA and all the Funds established under section 29 of the PFO except the Lotteries Fund.

(d) The components of the Government's loans and investment portfolios are disclosed in the annual accounts, although such disclosure is not required under the cash basis of accounting.

(e) Variance analyses are provided to explain any major difference between the original estimates and the actual revenue and expenditure Heads under the GRA.

3.3.2 The major deficiencies of the current financial reporting policies are set out below –

<u>Boundary of Government Financial Reporting</u>

(a) The Consolidated Account merely combines the GRA and various Funds established under section 29 of the PFO except the Lotteries Fund. It reflects most but not all of the Government's financial activities. For example, other Funds created for meeting specified government purposes and predominantly financed by the Government are not reported in the published accounts. The Government's ownership interests in the net assets/equity of Government-owned corporations, Trading Funds and relevant statutory bodies are also not fully reflected in the accounts.

<u>Assets and Liabilities</u>

(b) There are inconsistencies in the treatment of some items of similar nature in different statements. For instance, although loans and investments are reported as assets in the Statements of Assets and Liabilities for the CIF and the Loan Fund, they are excluded from the Statement of Assets and Liabilities for the Consolidated Account.

(c) Assets currently reported in the annual accounts are confined to those listed in paragraph 2.11.1(b). All the remaining assets employed by the Government, i.e. infrastructure assets, buildings, plant and equipment, are excluded.

(d) Investments, loans and advances are reported or disclosed at cost in the financial statements. They are not written down, where necessary, to reflect any loss of values.

(e) Liabilities currently reported in the annual accounts are confined to those listed in paragraph 2.11.1(d). Significant liabilities and commitments which are not accounted for or disclosed include –

- Pensions (including benefits payable under the Widows and Orphans Pensions Scheme (WOPS) or Surviving Spouses' and Children's Pensions Scheme (SSCPS)), contract gratuities and untaken leave of Government employees, and government borrowing, if any

- Commitments on capital expenditure

Revenue and Expenditure

(f) The surplus or deficit for a year is determined without excluding receipts and payments of a capital nature –

- Receipts of non-revenue nature (e.g. proceeds from borrowing and sale of investments)

- Payments of non-expenditure nature (e.g. loan payments and acquisition of investments)

Users of the financial statements therefore may not be able to readily appreciate and distinguish the level of resources required to finance the Government's operating, investing and financing activities respectively.

(g) Departmental expenditure analyses (i.e. Statement of Expenditure Analysis by Head and Subhead) do not include all the cash expenditure of a department/bureau because some expenditure payments are made under central votes (e.g. GRA Head 46 – General Expenses of the Civil Service) or votes controlled by other departments (e.g. rental payments made by Government Property Agency (GPA) for other departments). In addition, non-cash expenditure comprising the accruing costs (e.g. depreciation and pensions) and notional costs (e.g. accommodation costs in respect of Government-owned offices) are not shown. As a result, the full costs of resources consumed by individual departments/bureaux are not available.

(h) No expenditure analysis by different policy area groups (i.e. the purpose of the expenditure), such as education and social welfare, is provided although allocation of resources is made on such basis.

(i) In addition to the requirement that the current year expenditure may not exceed the annual estimate, the cumulative expenditure of each CWRF subhead also may not exceed the approved project estimate. In the Statement of Project Payments under the CWRF, however, the approved project estimate and the cumulative expenditure are not shown to demonstrate compliance with the latter requirement.

(j) Depreciation is not provided to spread the costs of fixed assets over their estimated useful lives to reflect the consumption of economic benefits embodied in the assets.

(k) Accrued expenditure on pensions (including the WOPS/SSCPS), earned contract gratuities and untaken leave is not provided to reflect the resources consumed in the reporting period.

3.4 In summary, the predominant strength of the current financial reporting of the HKSAR Government is that it demonstrates compliance with budget appropriations and stewardship of cash spending. This meets the first major objective stated in paragraph 3.2. On the other hand, there are deficiencies which need to be addressed in order to better present the financial performance and financial position of the Government and the stewardship information, thereby meeting the other four major objectives as set out in paragraph 3.2.

## Other Jurisdictions and International Accounting Standards

3.5 In formulating recommendations to improve government financial reporting, the Task Force has made reference to the financial reporting policies and practices of a number of developed countries and to the international public sector accounting standards. The findings and observations are set out in the following paragraphs.

3.5.1 Financial Reporting of A Number of Developed Countries

(a) Traditionally, financial accounting and budgeting for governments have been on the cash basis. Since 1980s, some developed countries have moved from the cash basis of accounting to the accrual basis[3], and among them, some have also adopted or plan to adopt accrual budgeting.

[3] A summary of the main differences between the two bases of accounting is at Annex 4.

(b) The public sector financial reporting environment is currently characterised by a spectrum of practices between cash accounting and accrual accounting. Governments around the world adopt a variety of reporting practices along the spectrum to meet their particular reporting objectives. This observation is shared by international bodies such as the Organisation for Economic Co-operation and Development.

(c) For the purposes of this review, we have focused on studying the experiences in the adoption of financial reporting policies by six countries, viz. Australia, Canada, New Zealand, Singapore, United Kingdom and U.S.A. Annex 5 gives a brief description of the experiences of these six countries while Annex 6 presents a summary of their current financial reporting and policies. The salient points are –

- While Singapore is using cash accounting, the other five countries have adopted, to differing extents, accrual accounting.
- 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.
- As can be seen from Annex 6, despite the fact that accrual accounting is adopted by the five said countries, the detailed treatments for individual items of assets, liabilities, revenue and expenditure vary considerably among those countries and there is no standardised approach.

(d) According to the experience of the countries where accrual accounting has been implemented, the perceived benefits generally include –

- Information on the full cost of resources consumed in the delivery of services is made available for informed decision making, evaluation and planning.
- Comprehensive reporting of revenue, expenditure, assets and liabilities enables the government to enhance transparency and to better discharge its accountability to the public.

- Proper accounting of assets promotes improved management of the assets.
- It provides a better financial management framework to enable better accountability of resources in general and performance reporting by public sector managers.

As compared with cash accounting, accrual accounting entails increased costs (both initially and on an on-going basis) caused mainly by –

- Development and maintenance of more sophisticated accounting and financial information systems
- Efforts spent on identification and valuation of fixed assets
- Development and maintenance of more extensive sets of accounting policies and standards
- Staff training and auditing requirements

Based on the experience of the aforesaid countries, it is difficult to separately quantify the costs arising from the implementation of accrual accounting since the change was usually part of the public sector and financial management reforms.

3.5.2 International Public Sector Accounting Standards (IPSASs)

(a) The IFAC is an organisation of national professional accountancy organisations that represent accountants employed in different sectors. The Public Sector Committee (PSC), which is a standing committee of the Council of the IFAC, is authorised to issue IPSASs on behalf of the Council to improve the quality of financial reporting in the public sector around the world.

(b) Before IPSASs are officially promulgated, all proposed standards are issued in the form of Exposure Drafts (EDs) for public consultation. As of 15 June 2002, seventeen IPSASs had been issued and five proposed standards (i.e. EDs) were still outstanding. A list of these IPSASs and EDs is at Annex 7.

(c) The IPSASs are largely based on the International Accounting Standards (IASs) developed for private sector enterprises.

## Overall Views of the Task Force

3.6 While there are advantages to be gained from following all the requirements of IPSASs and the practices of some of the developed countries referred to in this review, the Task Force considers that there are circumstances in which a direct adoption of the overseas practices may not be most appropriate given the local situation and the costs and benefits involved. Nevertheless, the Task Force has taken into account the overseas developments and considered the merits of different reporting practices. A pragmatic approach has been adopted in formulating the recommendations aiming at implementing substantial improvements in the Government Accounts to achieve the financial reporting objectives identified in paragraph 3.2 above. The detailed deliberations of the Task Force and the overall conclusions and recommendations to improve the financial reporting of the HKSAR Government are set out in Chapters 4 and 5 respectively.

# Chapter 4 Deliberations

## Cash Budgeting and Cash Accounting

4.1 Currently, funds are appropriated on an annual basis to government departments and bureaux to meet their anticipated cash expenditure requirements for the programmes undertaken during a year. Controlling officers are designated, generally as Heads of departments and bureaux, to be responsible for the expenditure incurred during the year, and they are obliged to closely monitor that the cash limits of their budgets are strictly observed.

4.2 In drawing up its recommendations, the Task Force notes that the current budgeting process including the appropriation will remain unchanged (i.e. on the cash basis). An inherent requirement of an effective budgetary control system is that financial reporting and budgeting should be on the same basis in order to allow controls to be implemented and comparisons between the actual revenue and expenditure and the approved estimates to be made effectively. It is therefore recommended that the existing cash-based accounts of the HKSAR Government should continue to be prepared and published.

4.3 While the cash-based accounts can effectively demonstrate the Government's compliance with budget appropriations and stewardship of cash spending, they fall short of the other four major reporting objectives as set out in paragraphs 3.2(b) to (e) and elaborated in paragraphs 3.3.2 and 3.4, i.e. to fairly present the financial performance and financial position of the Government and to demonstrate the resources it employs for the delivery of public services. Recognising the benefits which the implementation of accrual accounting may bring about, the Task Force has considered the preparation and presentation of a set of accrual-based accounts in addition to the existing cash-based accounts, taking into account the accounting principles laid down in the relevant Accounting Standards issued by the International Accounting Standards Committee (IASC), HKSA and IFAC.

4.4 The Task Force's deliberations on the various items presented in the Statement of Financial Performance and the Statement of Financial Position prepared under the accrual basis are set out in the following paragraphs. The Cash Flow Statement is not separately discussed in this Chapter since the principles underlying its preparation are basically the same as those currently adopted in the cash-based accounts of the HKSAR Government.

### *Items Presented in the Statement of Financial Performance*

### Revenue

4.5 The definition and recognition criteria of revenue are –

(a) Revenue is generally defined as the gross inflow of economic benefits during the accounting period when those inflows result in increases in net assets/equity, other than those relating to contributions from owners.

(b) Revenue is recognised, in the main, after the significant risks and rewards of ownership have been transferred (for the sale of goods) or by reference to the extent of completion (for the rendering of services), i.e. the revenue must have been earned. In addition, the following conditions should also be satisfied before revenue can be recognised –

- the amount of revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the entity;
- the costs incurred or to be incurred in respect of the transaction can be measured reliably; and
- the stage of completion of the transaction can be measured reliably (for the rendering of services).

4.6 It is important in the private sector to recognise revenue on the accrual basis in order to ensure revenue is accounted for in the same accounting period in which the relevant costs are incurred in earning the revenue so that revenue is <u>matched</u> with the relevant costs in the calculation of profit and loss. In contrast, the majority of services provided by the Government, such as education, social welfare and law and order, are financed not by the users of those services but (in whole or in part) from taxes and other non-exchange revenue[4]. The matching concept therefore does not apply in most cases since there is no direct relationship between revenue and the related costs.

[4] Exchange revenue generally refers to revenue earned from the rendering of services, sale of goods and assets and the use by others of assets yielding interest, rents, royalties and dividends. Non-exchange revenue is that derived from the use of legislative power to tax and levy duties, rates, fines and penalties.

4.7 The revenue of the HKSAR Government consists of exchange and non-exchange revenue. A significant portion of the Government's revenue is derived from the exercise of the power to tax and levy duties and rates rather than the sale of goods and services. The major types of revenue and the reporting issues are considered as follows –

4.7.1 <u>Non-exchange Revenue</u>

(a) The Government's non-exchange revenue includes –

- Duties – duties paid on hydrocarbon oils, alcoholic beverages, other alcoholic products and tobacco
- General Rates – rates levied on occupiers of rateable premises
- Internal Revenue – earnings and profits tax, bets and sweeps tax, stamp duties, estate duty, etc.
- Motor Vehicle Taxes – taxes for the registration of motor vehicles
- Fines, Forfeitures and Penalties – fines imposed by the courts and penalties imposed by statute, forfeitures resulting from court orders or from breach of contracts and agreements, etc.

(b) The above types of revenue are not obtained in return for goods or services provided. The matching of revenue and the related costs therefore does not apply.

(c) In theory, under the accrual basis of accounting, non-exchange revenue should be recognised when the transactions or events giving rise to the liability to pay occur.

This, however, is not always possible in practice. For instance, theoretically taxation revenue should be recognised in the year of assessment when the transactions and events giving rise to the liabilities occur, but in practice this is not possible because normally the amounts of tax payable are only determined quite some time after the year to which they relate. Alternatively, the revenue may be recognised only when the amounts can be measured reliably and the revenue is expected to be collectible, i.e. when a notice of assessment is issued. However, using this basis is not very different from recognition on the cash basis as there is generally little time difference between these two points. It merely advances the timing of recognition by a few months and the benefit so derived is questionable.

(d) Due to its special nature, most non-exchange revenue may not lend itself to be accrued easily (e.g. salaries tax and profits tax as mentioned above) or there is indeed no need to accrue it at all (e.g. vehicle first registration tax because the tax is paid shortly after sale and before the vehicle can be put on the road).

4.7.2 Exchange Revenue

(a) The Government's exchange revenue includes –

- Royalties and Concessions – royalties paid by franchised companies and revenue arising from various concessions
- Properties and Investments – yields from government land licences, government rents, rents from government quarters and properties, investment income and interest, etc.
- Utilities – income generated by Government Utilities
- Fees and Charges – fees and charges collected for services provided by government departments and bureaux
- Land Premium – sales by public auction and tender, private treaty grants and modification of existing leases, exchanges and extensions (to be further discussed in paragraph 4.7.4 below)

(b) For fees and charges, the revenue collected may be matched with the cost of services provided. However, for the majority of the Government's exchange revenue, e.g. land premium, royalty and franchise fees, the relationship between revenue and costs either does not exist or is tenuous. The accounting treatment for these kinds of revenue should therefore be similar to those for non-exchange revenue.

4.7.3 Impact of Adopting Accrual Accounting on the Reported Revenue

(a) Notwithstanding the above deliberations, Annexes 8 and 9 attempt to identify the bases and possible points of recognition for various types of the Government's non-exchange revenue and exchange revenue respectively, and estimate the effect of accrual accounting on the published accounts had they been adopted.

(b) Adopting the accrual-based recognition criteria set forth in Annexes 8 and 9 will have the effect of advancing the dates on which revenue is recorded in the accounts – from the date of receipt (i.e. cash basis) to the date when the revenue to be collected can be measured reliably (i.e. accrual basis) which is earlier in nearly all cases. The only exception is rental income from "short term tenancies" and "short term waivers", whereby the received rents and fees, collected before the commencement of the period concerned, have to be set aside as deferred income and transferred to the revenue account periodically according to the time elapsed. As can be seen from Annexes 8 and 9, accounting for revenue on the accrual basis will have a very small impact on the Government's total revenue as reported at present.

(c) By recognising only receipts in a year, the cash basis will exclude revenue that has arisen but has not been received. However, the net effect of accruing revenue for a particular year is unlikely to be material because the amount of accrued revenue brought forward from one year and accrued revenue carried forward to the next year do not differ significantly (unless there is a material change in activity levels) and tend to cancel each other out.

4.7.4 Land Premium

(a) Land premium is one of the major sources of the Government's revenue which merits separate consideration. On the accounting treatment of land premium income, there are two options –

- Land premium received by the Government on the lease of land is recognised over the leasehold period. Instead of recognising the entire proceeds as revenue in the year in which they are received, only a portion (normally one-fiftieth) of the premium is included as revenue each year throughout the term of the lease.

  This option is based on the argument that no real sales of land are made because the Government only grants, for each "sale", a fixed term of lease (usually fifty years) during which the "buyer" is required to pay an annual government rent calculated at 3% of rateable value of the piece of land sold. As such, the land premium is only a form of additional rent and should be recognised over the period covered by the lease so as to produce an even rate of return over the lease period.

- Land premium is fully recognised as revenue when received.

  This option is based on the argument that the granting of a land lease is in substance a sale transaction. Unless the Government exercises its right to resume the land for certain required purposes, renewal of the lease is normally granted without requiring further significant land premiums to be paid. For accounting purpose, the land premium can be fully recognised as sale proceeds when received.

(b) A well founded accounting convention (i.e. “substance over form” as promulgated in the “Framework for the Preparation and Presentation of Financial Statements” issued by IASC) is that transactions should be accounted for and presented in accordance with their substance and economic reality and not merely their legal form. Applying this principle to land sales, it can be construed that a land premium should be accounted for as if a sale has been made. It is therefore recommended that land premiums should be fully recognised in the year in which sale proceeds are received as they are now. The matching of land premiums with the costs of land sales (including land formation costs and the costs of facilities such as the construction of roads and drains) will be further discussed in paragraph 4.18.4(b) below.

Summary of Deliberations on Revenue

4.8 In summary, it is recommended that the Government’s revenue be recognised when it is received in view of the unique nature of most of the Government’s revenue (as compared with those of private sector enterprises), the irrelevance of matching revenue with the related costs in most cases and the only marginal benefits (in terms of the impact on the published accounts) which would be gained from reporting revenue on the accrual basis. Nevertheless, it is acknowledged that this recommendation is not entirely consistent with gaaps including IPSASs and should be kept under review to determine whether a greater degree of conformity might be achieved when the costs and effort for obtaining the required accrual data become less, for example, after the introduction of the new Government Financial Management Information Systems (GFMIS) in the next few years.

Receipts of Non-revenue Nature

4.9 Under the existing cash-based accounts of the Government, the reported revenue has included some of those receipts which should not be recognised as revenue according to the definition quoted in paragraph 4.5 above. These receipts of non-revenue nature are considered as follows –

(a) Repayments of loans received during the year are currently included as revenue in the GRA, the CIF and the Loan Fund. Receipts from these sources do not represent an inflow of economic benefits to the Government because a loan repayment only converts the Government's owned assets from one form to another (i.e. from loan to cash). Therefore, repayments of loans should not be reported as revenue in the Statement of Financial Performance.

(b) Similarly, on the sale of investments and disposal of properties, only the profit rather than the gross proceeds should be recognised as revenue. In case of loss on sale or disposal, the amount of loss should be recognised as expenditure.

(c) Proceeds from government borrowings, if any, are not revenue by nature but are cash inflows from financing activities. They should therefore not be reported as revenue in the Statement of Financial Performance.

**Expenditure**

4.10 The definition and recognition criteria of expenditure are –

(a) Expenditure is generally defined as decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.

(b) Expenditure is recognised when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

4.11 The major issues pertaining to the reporting of expenditure of the HKSAR Government are considered as follows –

4.11.1 <u>Expenditure in General</u>

(a) Under the accrual basis of accounting, goods and services that have been consumed but not yet paid for should be charged as expenditure in the year in which they are consumed and at the end of the reporting period included as liabilities in the Statement of Financial Position. As can be seen from Annex 10, adopting the concept of accrual accounting will only make an insignificant difference to the Government's recurrent expenditure reported on the cash basis. This is mainly due to the fact that –

- 80% of the Government's recurrent expenditure is composed of subventions, social security payments and staff salaries. Most of these types of expenditure are paid in the same period to which they relate.

- Accrued expenditure at the end of one year is unlikely to differ significantly from that at the end of the previous year (unless there is a material change in economic activity levels).

(b) On the other hand, considerable costs and effort will be required to ascertain the accrued expenditure and the related accounts payable at the end of the accounting period. There is no accrual functionality in the Government's existing cash-based accounting system which has been providing general ledger functions to government departments and bureaux. In the absence of such accrual functionality and automated processes, laborious manual work will need to be performed in order to calculate the amounts involved.

(c) On balance, it is recommended that the Government's expenditure, save for those discussed in paragraphs 4.11.2 to 4.11.5 below, be recognised when it is paid (i.e. same as the existing cash basis). However, it is acknowledged that this will not fully comply with gaaps including IPSASs and should be kept under review particularly after the introduction of the new GFMIS in the next few years when the costs and effort for determining expenditure on the accrual basis may become less.

4.11.2 Depreciation and Capital Expenditure

(a) Depreciation should be provided in the Statement of Financial Performance to spread the costs of fixed assets over their estimated useful lives so as to reflect the consumption of economic benefits embodied in the assets. The annual charge can be based on predetermined depreciation rates for the respective categories of fixed assets.

(b) Capital expenditure which provides benefits for more than one accounting period should be reported in the Statement of Financial Position as assets. As the economic benefits embodied in an asset are consumed, the carrying amount of the asset is reduced to reflect this consumption, normally by charging an expense for depreciation over the asset's estimated useful life in the Statement of Financial Performance. As will be discussed in detail in paragraphs 4.18.3 and 4.18.4 below, the major categories of capital expenditure to be treated in this manner include –

- Buildings, plant and equipment employed by the Government (but excluding those school premises and hospitals not controlled and managed by the Government); and

- Infrastructure assets of Government Utilities which collect charges from consumers (e.g. water supplies, sewerage services, toll-tunnels and bridges).

4.11.3 <u>Pensions</u>

(a) The Government's pensions expenditure consists mainly of the benefit payments under the Public and Judicial Service Pensions Schemes and WOPS/SSCPS.

(b) The pensions expenditure reported in the existing cash-based accounts is confined to actual benefit payments made during the year. Under the accrual basis, however, pension benefits accrued during the year together with any adjustments to accumulated pensions provision should be included in the Statement of Financial Performance as expenditure, such that the accumulated pensions provision in the Statement of Financial Position plus the anticipated investment returns thereon would be sufficient to pay for accrued pension benefits. Payments of pension benefits will be charged to the provision account.

(c) Under the accrual basis, the accrued pensions expenditure for a year include –

- Current service cost – this is the amount of pension benefits accrued during the year. This cost will be calculated by using a set of pre-determined rates (based on salaries, contributions, etc.) recommended by professional actuaries at each periodic valuation of the Government's pensions liabilities.

- Interest cost – this represents the investment return that would otherwise have been earned in the year had the accumulated pensions provision been invested. As can be seen from paragraph 4.11.3(b) above, the cumulative amount of pensions provision alone will not be sufficient to pay for accrued pension benefits and it will be necessary for interest cost to be provided if the accumulated pensions provision is not represented by investment. Interest cost can be calculated assuming the same rate of investment return used in valuing the pensions liabilities.
- Adjustments to accumulated pensions provision, if any, recognised during the year in respect of under- or over-provision made in previous years. The adjustment amounts will be based on the recommendation of independent actuaries made at periodic valuation of pensions liabilities.

(d) The principles and practice of pensions provision will be further discussed in paragraph 4.20.1 below.

4.11.4 Contract Gratuities

(a) Gratuities to be paid to government contract staff should be accrued as an expense in the Statement of Financial Performance in the periods during which the services are rendered and reported as a liability in the Statement of Financial Position until they are paid.

(b) The annual charge for contract gratuities will be determined on the basis of the gratuity rates and salaries of individual staff, reduced by the Government's Mandatory Provident Fund (MPF) contributions made during the year.

4.11.5 Leave Earned but not Taken

(a) Leave earned but not taken by government employees during a year should be accrued in the accounts as expenditure. Untaken leave is an actual liability as when an employee takes leave subsequently, no output is achieved while salaries continue to be paid.

(b) The annual charge for leave earned but not taken (i.e. the excess of the closing leave balance over the opening leave balance of the reporting period) can be calculated by reference to the leave balances of individual staff and salaries.

Summary of Deliberations on Expenditure

4.12 In summary, it is recommended that –

(a) Subject to (b) and (c) below, the Government's expenditure is recognised when it is paid (i.e. same as the existing cash basis) in view of the nature of most of the Government's recurrent expenditure and the only marginal benefits (in terms of the impact on the published accounts and as compared with the costs involved) which would be gained from reporting expenditure on the accrual basis. Similar to the recommendations for revenue in paragraph 4.8 above, this recommendation is also not entirely in compliance with gaaps including IPSASs and should likewise be kept under review, particularly after the implementation of the new GFMIS when the costs and effort for obtaining accrual data may become less.

(b) Depreciation is provided to spread the costs of fixed assets over their estimated useful lives so as to reflect the consumption of economic benefits embodied in the assets.

(c) Accruals are made for major cost components including the civil service pensions, earned contract gratuities and leave earned but not taken in order to fairly reflect the value of resources consumed in the reporting period.

Payments of Non-expenditure Nature

4.13 Under the existing cash-based accounts of the Government, the reported expenditure has included some of those payments which should not be recognised as expenditure according to the definition quoted in paragraph 4.10 above. These payments of non-expenditure nature are considered as follows –

(a) Investments and loans made during the year are currently included as expenditure in the Consolidated Account. Payments for these purposes do not represent a decrease in economic benefits because they only involve a conversion of the Government's owned assets from one form to another (i.e. from cash to investments and loans). Therefore, investments and loans should not be reported as expenditure in the Statement of Financial Performance.

(b) Similarly, repayments of government borrowings, if any, are not expenditure by nature but are cash outflows from financing activities. They should therefore not be reported as expenditure in the Statement of Financial Performance.

### *Items Presented in the Statement of Financial Position*

**Assets**

4.14 The definition and recognition criteria of an asset under gaaps are –

(a) An asset is generally defined as a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

(b) An asset is recognised when it is probable that future economic benefits associated with the asset will flow to the entity and the cost of the asset can be measured reliably.

4.15 In the private sector, the main objectives of an entity are to make profits, to maximise the value of the shareholders' equity, and to maintain its continuity and growth, and resources are employed to those ends. Under such an operating environment, assets are those which are either held and used to generate income or can be converted into cash and cash equivalents when necessary to finance the business operations or for distributions to shareholders or owners. Therefore, in the definition of assets in private sector accounting, the inflow of "future economic benefits" is an important element.

4.16 The objectives of government, on the other hand, are more concerned with improving the well-being of the society as a whole, and expenditure is incurred and resources (and assets) are employed for the delivery of public services consistent with government policies. Some government services are provided free of charge or at fee levels below their full costs and as a consequence, in contrast to private sector enterprises, the assets of a government do not necessarily bring about inflow of economic benefits. The government's assets may therefore include those which are used to deliver public services consistent with its objectives but which may not directly generate net cash inflows. These assets are described as embodying "service potential".

4.17 In the context of public sector accounting, the IFAC considers that the definition of an asset should incorporate the capacity to deliver either economic benefits or service potential. Accordingly, resources employed to deliver goods and services, though not generating any cash inflows at all, should also be recognised as assets according to the IFAC. The Task Force considers that while there are merits in following this standard because it helps to demonstrate the accountability, we must strike a balance between the costs and benefits involved in defining the policies for the inclusion of material assets either in the Statement of Financial Position or in the Stewardship Statement. These will be further discussed in the following paragraphs.

4.18 The major types of assets of the HKSAR Government are considered as follows –

4.18.1 <u>Financial Assets</u>

(a) Financial assets refer to those assets in the form of cash and realisable assets which are convertible into cash. They have clear future economic benefits and their value can normally be measured with reliability. The financial assets of the Government consist mainly of bank deposits, investments, loans and advances. They should be reported in the Statement of Financial Position in order to give a fair presentation of the financial position of the Government.

(b) Investments and loans are required to be reported, to the extent that they are expected to be recoverable, in the Statement of Financial Position. Accordingly, all the loans and investments made under the Loan Fund and the CIF are recognised as assets and the portfolios should be periodically reviewed to determine whether any write-off or write-down of the reported values is required. The amount of the write-off or write-down should normally be charged as expenditure immediately in the Statement of Financial Performance.

(c) As an example in connection with (b) above, it is considered that the Government's contribution to the HKHA for domestic housing development (being the cumulative value of land provided), currently reported as an investment in the CIF, should be written off in the Government's books because the contributions are not recoverable and are more in the nature of government subsidies.

(d) In line with the recommendation in paragraph 4.8 above that the Government's revenue is recognised on the cash basis, revenue receivable and accounts receivable can be ignored.

4.18.2 Stocks in Hand

(a) Stocks in hand are stores, parts and consumables for own consumption in the course of the Government's operations. The amounts involved in most cases are not material except for the stocks held by some departments such as Government Supplies Department, Water Supplies Department and Police. Some of these stocks in hand are already being reported in the existing Statements of Assets and Liabilities under the Suspense Accounts as noted in paragraph 2.11.1(b) above.

(b) Stocks in hand should be reported in the Statement of Financial Position to the extent that they are material. Materiality will be determined by reference to the circumstances of the departments concerned as well as the absolute amounts of stocks involved.

4.18.3 Buildings, Plant and Equipment

(a) Buildings, plant and equipment are tangible assets that –

- are held by an entity for use in the production or supply of goods and services, for rental to others, or for administrative purposes; and
- are expected to be used for more than one accounting period.

(b) Buildings cover properties occupied for the delivery of public services (including general office buildings as well as purpose-built buildings such as police and fire stations) and community and recreational facilities (such as town halls, carparks and multi-purpose complexes). There should be benefits of including buildings in the Statement of Financial Position as it will better demonstrate the resources employed for the delivery of public services.

It is nevertheless considered very costly and impracticable to measure accurately and reliably all the above types of buildings in the Statement of Financial Position. The buildings are dispersed throughout the territory and some of them may have been constructed many years ago for different purposes and of different designs. The original construction costs of these buildings cannot be readily ascertained. Some assets may have been constructed or acquired as a part of a bigger project and their costs may not be ascertained without making reference to the detailed payment and contract records. It is therefore recommended that the policies on the capitalisation of buildings be initially stated as –

- Buildings used to deliver government services are capitalised as fixed assets in the Statement of Financial Position; and

- Minor building structures (e.g. refuse collection points and public conveniences) are not capitalised as fixed assets. It may not be cost effective to identify and value them all because they are relatively small in value but large in quantity. Similarly, surplus or obsolete buildings (e.g. Vietnamese Centres and the remaining facilities at Kai Tak after the closure of the airport) are not capitalised since they will soon be disposed of or demolished.

(c) It is recommended that plant and equipment which are also part of the resources employed by the Government for the delivery of public services should be capitalised.

(d) Buildings, plant and equipment which are controlled and managed by the subvented sector or public bodies (e.g. hospitals and school premises managed by the Hospital Authority and aided schools respectively) should be excluded from the Government's accounts, despite the fact that the ownership of these assets may be retained by the Government. They are reflected as resources consumed in the Government's accounts by way of the capital grants and subventions given as they were being acquired or built.

(e) To minimise the costs and effort involved in identifying and valuing a large number of fixed assets currently in use by the Government, it is recommended only existing fixed assets with an estimated depreciated value of $1 million or more will be reported as fixed assets. For fixed assets acquired from 2002-03 onwards, a lower threshold same as that adopted for Capital Account expenditure of the GRA, which is $100,000 at present, should be adopted. This should represent a more appropriate balance between costs and benefits.

(f) Buildings, plant and equipment will be reported in the Statement of Financial Position –

- initially at cost (i.e. the amount paid for the acquisition or construction of an asset) or fair value (i.e. depreciated replacement cost[5]) if the cost cannot be determined reliably (e.g. due to inadequate or non-existent records) or is not relevant (e.g. acquired at nil or nominal consideration); and

- subsequently at cost less any accumulated depreciation and any accumulated impairment losses or, alternatively, at valuation. Revaluation should be made with sufficient regularity so as to reflect the fair value at the reporting date.

It is preferable that assets are carried at depreciated replacement cost, in particular when the historical costs are not available or, because of inflation, the historical costs do not appropriately reflect their current values. However, in order to minimise the cost and effort required to value the Government's huge number of existing fixed assets, it is recommended that valuation should be made on the basis of depreciated historical cost if it can be ascertained without great difficulty or effort. Otherwise, depreciated replacement cost should be used. It is noted that valuation on the basis of historical cost is generally used by local utility companies in valuing their fixed assets.

(g) Staff costs incurred by works departments in planning, design and supervision of CWRF projects (including buildings, plant and equipment and infrastructure assets) are partly included as salaries under the relevant department's own Head and partly as staff fringe benefits paid under central votes. In theory, it is necessary to take out the corresponding staff cost from the GRA (i.e. by way of an adjustment to the relevant Heads) and to include them as part of the cost of the fixed assets. However, this cost is likely to be quite insignificant in relation to the assets involved and as it will be very complex to determine the amount in each case, it is recommended that it will not be included initially.

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[5] Depreciated replacement cost is the cost of replacing an existing asset with an identical or substantially similar new asset having a similar production or service capacity, from which appropriate deductions are made to reflect the value attributable to the remaining portion of the total useful economic life of the asset.

(h) To demonstrate the Government's accountability for the resources employed, it is recommended that information on the areas of buildings used by the Government analysed by policy area groups (e.g. housing, education and health) be disclosed in the Stewardship Statement to be published with the Government's annual accounts.

4.18.4 <u>Infrastructure Assets</u>

(a) Infrastructure assets are characterised as major expenditure on immobile specialised assets (e.g. roads, bridges, piers, tunnels, sewerage and water supply systems) which have no alternative use and generally will not have a realisable value or earning potential.

(b) The costs incurred on infrastructure assets are mostly sunk costs – expenditure from previous years that cannot easily be realised, if at all. Most of the infrastructure assets not only do not generate revenue but in fact require servicing on an ongoing basis and cannot be realised. Capitalisation of all these assets is tantamount to deferring the recognition of expenditure. It is also considered very costly and impracticable to value and include all infrastructure assets in the Statement of Financial Position. However, for those infrastructure assets generating revenue or expected to generate revenue which will recover a significant part of the costs, their values should be reported in the Statement of Financial Position as this will better demonstrate the resources employed for the delivery of public services. Examples of this kind of assets include the infrastructure assets of Government Utilities, and their historical costs can be ascertained from the respective Operating Accounts (please see paragraph 2.14(b) above). It is therefore recommended that the policies on the capitalisation of infrastructure assets be established as follows –

- Expenditure on infrastructure assets of Government Utilities the use of which generate charges from consumers (e.g. water supplies, sewerage services, toll-tunnels and bridges), thereby recovering a significant part of their costs from users, are capitalised as fixed assets.

- Expenditure on other infrastructure assets which do not generate charges from consumers (e.g. roads and drainage) are not capitalised as fixed assets.

As noted in paragraph 4.7.4(b) on land premium, the infrastructure expenditure, including the land formation cost and cost of facilities such as the construction of roads and drains, contributes directly or indirectly to the value of the land sold by the Government. Such expenditure can thus be regarded as the cost of land sales. Since the land premiums received from land sales are credited to the CWRF to finance wholly or partly infrastructure works, there is, over time, an approximate matching relationship between the land premiums and the infrastructure expenditure. Both are recommended to be accounted for on the cash basis as explained in paragraph 4.7.4(b) above on the recommended treatment for land premium.

- To better discharge the Government's responsibility of accounting for the resources under its stewardship, it is recommended to publish supplementary non-financial information on infrastructure assets such as roads and drainage (measured in terms of areas or lengths) in the Stewardship Statement.

4.18.5 Land

(a) Different types of land relevant to the Government's financial reporting are considered as follows –

- Undeveloped land such as country parks, hills, etc.

- Developed land: this can be further broken down into the following categories –

  - Land for which a use has yet to be decided (including those pieces of land under short-term tenancies or short-term waivers)

  - Land under infrastructure assets (such as roads, streets, airport, landfills, etc.) and public facilities (such as parks, playgrounds, swimming pools, public conveniences, etc.)

  - Land occupied by the Government –

    (i) for uses unique to the Government (such as police stations, fire stations, prisons, etc.) and no parallel instances can be found in the private sector

(ii) for general uses (such as offices, warehouses, carparks, etc.) and counterparts can be found in the private sector

- Land allocated for domestic public housing developments
- Land granted at a nominal or reduced premium to religious bodies, subvented organisations, etc.
- Land held for sale (i.e. those pieces of land in the land sale programmes)
- Land allocated for investment purposes

(b) While there are advantages to be gained in terms of transparency and accountability for *all* government land to be reported in the Statement of Financial Position, it may not be possible to do so for the *majority* of the land owned by the Government because objective valuation cannot be obtained as either –

- the use of the land has not been determined yet; or
- the use of the land has no parallel instance in the private sector to which reference can be drawn to make the valuation (e.g. police stations).

Since the value of a piece of land is inextricably linked to its use, no meaningful valuation can be made until the use of land is determined. Some may suggest that valuation can be based on the best possible use but this is unrealistic and will significantly overstate the value. Obviously the Government cannot designate the use of every piece of land to the best possible use – consideration must be given to both environmental issues and town planning needs including the provision of essential public services and amenities – not to mention the ability of the property market or the industry concerned (e.g. hotel) to absorb all the land involved which, even spread over many years, is very substantial. These difficulties or constraints also apply when attempts are made to value those pieces of land under infrastructure assets and public facilities and the land occupied by the Government for uses (e.g. prisons) not found in the private sector. Even for the land which has a parallel use in the private sector (e.g. hospitals and schools), it may not always be feasible to arrive at a meaningful valuation by making reference to the land premiums collected from the private sector because (i) the actual land premiums available may be outdated (e.g. very few private hospitals have been constructed in recent years); and (ii) the number of the pieces of land in the private sector dedicated to a particular use is rather small in comparison with that in the public sector (e.g. hospitals) and it may not be appropriate to base a large number of land valuations on few cases in which land premiums were paid many years ago.

For those pieces of land occupied by government offices, warehouses, etc. which have their counterparts in the private sector, there should be no problem in obtaining an objective valuation.

For land allocated for domestic public housing developments, valuation can be made by reference to the land premiums paid by the private sector for comparable residential developments. In fact, the value of this kind of land (amounted to $285 billion as of 31.3.2001) has been reported in the Statement of Assets and Liabilities of the CIF as part of the Government's investment in the HKHA. However, it is doubtful if the valuation is meaningful as (i) the amounts of rental collected from domestic housing are, over the years, consistently insufficient to cover the relevant operating costs; and (ii) it will be difficult, if not impossible, for the Government to take back the land for sale and sales to sitting tenants are made at heavily discounted prices (representing 20% - 45% of the market value depending on the timing of purchase) and limited to flats of certain age brackets.

For land granted at a nominal or reduced premium to religious bodies, subvented organisations, etc., it may be suggested that the Government should report the difference between the market value of the land and the actual amount of land premium received as a subsidy to these entities in the Statement of Financial Performance. However, since the amounts of revenue foregone for these kinds of land grants are relatively small in terms of both the number of grants made each year and the value of land premium involved in each case, there appears to be no need to include these subsidies in the Statement of Financial Performance. In any case, it will be difficult, if not impossible, to obtain a valuation that can reflect the restrictive charitable or religious use under which the particular land grant is made.

For land held for sale (i.e. those pieces of land in the land sale programme), it may be suggested that this kind of land should be reported in the Government's balance sheet because it is clearly meant for disposal and valuation can be made at market values. To report this kind of land in the balance sheet, it will require a subjective assessment or estimate to be made of the property market several years (depending on the scheduled timing of sale) into the future. It is doubtful any valuation thus obtained will be of any use or value at all considering the volatility of the property market.

For land allocated for investment purposes (e.g. in Trading Funds), the values have already been included in investments reported in the Statement of Assets and Liabilities of the CIF.

(c) It is therefore apparent from the above discussions that, apart from the land allocated for investment purposes, only the land occupied by the Government for general uses (such as offices, warehouses, carparks, etc.) lend themselves to an objective valuation. However, the Task Force does not recommend valuation be made for this kind of land *at this stage* considering that –

- it represents only a small part of the land owned by the Government and to report it in the Statement of Financial Position while ignoring all the others is rather inconsistent and misleading;

- whether or not this kind of land is valued and reported as assets does not affect the Government's financial performance because land values, unlike other fixed assets, need not be depreciated and charged to the Statement of Financial Performance as expenses; and

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

(d) Recognising that land is a scarce resource in Hong Kong and the Government's duty of accountability in the stewardship of land, the Task Force recommends, *as a start*, that –

- For land occupied by the Government for delivery of public services: disclosure be made in the Stewardship Statement – in terms of areas analysed by policy area groups.

- For land allocated to the HKHA for domestic housing developments, disclosures be made –

  - in the Notes on the Accounts – in terms of (i) the numbers and the gross floor areas of the flats *sold* during the year or *pending sale* under the Home Ownership Scheme/Private Sector Participation Scheme (HOS/PSPS) or Tenants Purchase Scheme (TPS); and (ii) the cumulative areas of the land allocated for HOS/PSPS developments; and

  - in the Stewardship Statement attached to the Government's annual accounts – in terms of (i) the numbers and the gross floor areas of the flats *let or to be let*; and (ii) the cumulative areas of the land occupied by rental housing estates excluding the parts of the land occupied by commercial centres or carparks which will continue to be reported as investment.

  The reason underlying the difference in the reporting treatment is that the title to the flats sold belongs to the buyers and should not be reported as government owned assets in the Stewardship Statement.

- For land granted at a nominal or reduced premium to religious bodies, subvented organisations, etc.: disclosures be made in the Notes on the Accounts – in terms of the areas of the land granted in the year.

4.18.6 <u>Natural Resources</u>

Natural resources are economic resources in their natural and undeveloped state. It is recommended not to recognise natural resources as fixed assets since their value cannot be measured reliably.

4.18.7 Heritage Assets

Heritage assets are physical assets that a community intends to preserve because of cultural or historic importance, such as historic buildings and art collections. Similar to natural resource assets, their value cannot be measured reliably. It is therefore recommended not to recognise heritage assets as fixed assets.

4.18.8 Power to Tax, to Grant a Franchise,etc.

The powers to tax, to grant a franchise, etc. are derived from the legislative powers of a government, the value of which cannot be measured reliably as it is not certain to what extent they will be exercised in the future. It is considered that they are not assets but represent the powers of a government to derive future revenue.

4.18.9 Assets under the Build-Operate-Transfer Arrangements

(a) For assets constructed by the private sector under Build-Operate-Transfer (BOT) arrangements[6], both the title to the assets and the economic benefits arising from the assets are not passed to the Government until the arrangements expire.

(b) In view of the above, assets under the BOT arrangements cannot be reported as assets in the Government's Statement of Financial Position until the arrangements expire. However, it would be useful to provide a list in the notes on the Government's annual accounts setting out the names and the expiry dates of the relevant arrangements so as to provide the accounts users with information on the nature and timing of such resources which will become the Government's assets in the future.

[6] Under a Build-Operate-Transfer (BOT) arrangement, the Government enters into an agreement with a private sector company under which the company agrees to finance, design and build a facility at its own cost, and is given a concession, usually for a fixed period, to operate that facility and collect revenue from its operation before transferring the facility back to the Government at the end of the concession period.

(c) Upon expiry of the BOT arrangements, the relevant assets should be reported as assets in the Statement of Financial Position in accordance with the capitalisation policies recommended in paragraphs 4.18.3 and 4.18.4 above.

## Liabilities

4.19 A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. A provision may be made for known liabilities or expenditure for which the amount cannot be determined accurately. It is important to include all liabilities in the accounts of the Government so as to give a fair presentation of its financial position.

4.20 The major types of liabilities and provisions of the HKSAR Government are considered as follows –

4.20.1 <u>Provision for Pensions Liabilities</u>

(a) Accrued pension benefits should be recognised as liabilities in the Statement of Financial Position because they are present obligations of the Government. Although uncertainties exist as to the timing of the payments and the amounts involved, they can be factored in the determination of the amounts to be provided using actuarial methods.

(b) The amount to be reported as liabilities represents the total present value of payments expected to be made in the future in respect of benefits accrued to date taking into account all the factors that will affect the amounts of benefit payments such as future salary increases, attrition rates, mortality rates, the rates of investment return, inflation rates, etc. In view of the significant amount of the liabilities involved, it is essential to obtain independent valuation from professional actuaries. Periodic revaluations are also necessary.

(c) Between periodic revaluations by external actuaries, the pensions liabilities reported at the end of each year can be adjusted by the amounts of actual pensions payments and accrued pension expenditure calculated in the manner described in paragraph 4.11.3(c) above.

4.20.2 Provision for Contract Gratuities

As discussed in paragraph 4.11.4 above, accrued gratuities to be paid to government contract staff should be reported as a liability in the Statement of Financial Position until they are paid.

4.20.3 Provision for Untaken Leave

Untaken leave balances of government employees should be reported as a liability in the Statement of Financial Position (please see paragraph 4.11.5 above).

4.20.4 Government Borrowings

(a) In 1991-92 and 1992-93, Government Bonds were issued and they were disclosed in the notes on the Government's annual accounts for these years.

(b) Government borrowings, if any, are by nature debts owed by the Government and should therefore be reported as liabilities in the Statement of Financial Position.

4.20.5 Other Provisions

(a) Redemption money payable in respect of land exchange entitlements and interest payable thereon under the New Territories Land Exchange Entitlements (Redemption) Ordinance represents debts owed by the Government and should be reported as a liability in the Statement of Financial Position.

(b) Promissory notes issued to the Asian Development Bank represent commitments made by the Government to make contributions to the Asian Development Fund over a number of years. They are currently disclosed in the notes on the Government's annual accounts. The promissory notes issued are by nature debts owed by the Government and should therefore be reported as liabilities in the Statement of Financial Position instead of being just disclosed in the notes on the accounts as at present.

4.20.6 Accounts Payable

(a) Accounts payable are liabilities for goods and services delivered and unpaid or other accrued expenses.

(b) In line with the recommendation in paragraph 4.11.1(c) above that the Government's expenditure in general is recognised on the cash basis, accounts payable can be ignored.

## Reserves

4.21 In the private sector, the net worth of an entity is the excess of its assets over its liabilities, and the reporting of the net worth is one of the most crucial financial reporting objectives to meet the needs of investors, creditors, credit rating agencies, etc. However, for government financial reporting, it is considered that users of the financial statements are concerned with the sustainability of a government's operations which is judged by the ability of the government to raise sufficient revenue to cover its expenditure in the medium term and long term. In the particular circumstances of Hong Kong, it is also important to demonstrate the fiscal soundness of the HKSAR Government. Normally, the concept of net worth is only of limited significance in government financial reporting.

4.22 The recognition of fixed assets in the Statement of Financial Position as recommended earlier and the consolidation of the Exchange Fund (recommended in paragraph 4.26.2(a) below) will result in a very significant increase in the Government's net assets (i.e. total assets less liabilities). It should be noted that (i) fixed assets represent amounts already spent but capitalised and depreciated to spread the costs over their useful lives; and (ii) the use of the Exchange Fund is restricted by the Exchange Fund Ordinance for specific purposes (i.e. primarily to safeguard the exchange value of the Hong Kong dollar and to maintain the stability and integrity of Hong Kong's monetary and financial systems). In order to avoid possible confusion as to the amount available for the Government's disposal, it is considered necessary to clearly distinguish the amounts of the reserves relating to fixed assets and the Exchange Fund from other reserves. The Task Force recommends the following presentation of the Government's Reserves –

(a) General Reserve – representing the amount of net assets (total assets less liabilities) of the Government less (i) net assets of the Exchange Fund; and (ii) fixed assets;

(b) Exchange Fund Reserve – representing the amount of net assets of the Exchange Fund whose use is governed by the Exchange Fund Ordinance; and

(c) Capital Expenditure Reserve – representing the cumulative amount of funds already spent on the acquisition or construction of those fixed assets recommended in paragraphs 4.18.3 and 4.18.4 above to be capitalised after deducting cumulative depreciation (i.e. net fixed assets).

4.23 Under the existing cash-based accounts, the Government's Fiscal Reserve represents the level of <u>cash resources</u> available. The difference between Fiscal Reserve and General Reserve is as follows –

(a) Fiscal Reserve is the accumulated surpluses (determined on the same basis as the cash-based Budget) and comprises mainly cash and cash equivalents held under the GRA and various Funds established under section 29 of the PFO.

(b) General Reserve is the Government's net assets as shown in the recommended consolidated accounts (prepared on the accrual basis) after excluding (i) the net assets of the Exchange Fund; and (ii) fixed assets. It is of the same amount as the Net Financial Assets shown on the asset side. The consolidation boundary and principles are set out in paragraphs 4.26.1 and 4.26.2 below.

**Contingent Liabilities and Commitments**

4.24 The disclosure requirements concerning the contingent liabilities and commitments of the HKSAR Government are considered as follows –

4.24.1 <u>Contingent Liabilities</u>

(a) A contingency is a condition which exists at the end of the accounting period, where the outcome will be confirmed by the occurrence or non-occurrence of one or more uncertain future events.

(b) Where it is considered that no provision is necessary for those contingent liabilities existent at the end of the accounting period, both the nature and estimated amounts involved should be disclosed in the notes on the accounts unless the probability of a loss is remote. The items currently disclosed in the Government's annual accounts are already in line with this reporting practice.

4.24.2 Commitments

Commitments refer to obligations that will become liabilities if and when the terms of existing contracts, agreements or legislation are met. The amounts of commitments are required to be disclosed in the notes on the accounts.

## Consolidation

4.25 Consolidated financial statements are prepared by an entity to present the combined results and financial position of all the constituent entities and resources in a single set of financial statements.

4.26 The consolidation boundary, principles and methodology are considered as follows –

4.26.1 Scope of Consolidation

(a) In general, the scope of consolidation should encompass –

- Government-funded operations with the exception of non-departmental public bodies and other organisations funded by means of government grants and subventions; and

- Entities which the Government has a major ownership interest by way of equity holdings or capital investments, or in which the Government has a right over their net assets/surplus funds. However, entities in whose profits/reserves the Government as a matter of policy does not intend to participate are excluded.

*Government-funded operations*

(b) At present, the "Consolidated Account" of the Government includes the GRA and all the Funds established under section 29 of the PFO except the Lotteries Fund. It is considered that the Consolidated Account in future should include the GRA and all the Funds established under section 29 of the PFO.

The Lotteries Fund was excluded in the past because of its dedicated sources of revenue and usage (paragraph 2.9 above). As it now stands, the Civil Service Pension Reserve Fund and Land Fund are also subject to restrictive provisions limiting the use of the Funds and the CWRF also has dedicated sources of revenue. The Lotteries Fund should therefore be also included in the Consolidated Account.

(c) The consolidation should also include "Other Funds" (i.e. other than those set up under section 29 of the PFO) which have been created for meeting specified government purposes (e.g. Quality Education Fund (QEF)) and for whose use the Government is ultimately answerable. The major criterion for inclusion is that if the recurrent funding of a Fund comes mainly from the GRA or other forms of government injection, the Fund should be consolidated as these funds are considered to be little different from normal government operations. A list of "Other Funds" to be included in the consolidated financial statements is given in Annex 11.

*Government-owned corporations and other statutory bodies*

(d) For the investments in Government-owned corporations (e.g. MTRCL, KCRC and Airport Authority), the accounting treatment should reflect the nature of relationship between the Government and these entities. Despite the Government's significant equity holdings, these entities are managed independently.

In the circumstances, it should reflect the holding of an ownership interest by the Government in the form of equity, rather than treating these entities as part of government operations. In addition, the ownership interest should include the cost of investment as well as the undistributed profits retained in the accounts of these entities.

(e) From the Government's investment point of view, though Trading Funds have no separate legal identities and there is no transfer of ownership or ultimate responsibility from the Government, they are to some extent similar in substance to the equity holdings in Government-owned corporations. They should therefore be treated in the same way as Government-owned corporations.

(f) In order to fairly present the Government's financial performance and position, it is considered that the Exchange Fund should be included in the Consolidated Account of the HKSAR Government. It is noted that nearly half of the Western Hemisphere countries perform consolidation of central bank operations with those of the government in preparing the consolidated financial statements.

*Non-departmental public bodies and subvented sector*

(g) Non-departmental public bodies and subvented sector in receipt of recurrent and capital subventions from the Government are not part of the consolidation but are accounted for by way of the government grants and subventions given. This treatment is effectively to reflect the Government's involvement as the purchaser of services in furtherance of the relevant policy objectives.

(h) The Government provides land on concessionary terms to the HKHA for the development of public housing estates and HOS/PSPS flats. As HKHA's expenditure is met from its own revenue (e.g. income from rental and HOS/PSPS projects) and the Government does not provide grants, it is not possible to reflect the resources consumed by the HKHA by way of grants similar to other non-departmental public bodies. It is also not appropriate to consolidate the HKHA by the equity method[7] as the Authority is not intended to generate a return to the Government. The only viable option is to consolidate the HKHA on a line-by-line basis[7]. The land deployed for the provision of public housing is suggested to be disclosed in the notes on the Government's annual accounts and in the Stewardship Statement in the manner set out in paragraph 4.18.5(d) above.

4.26.2 Consolidated Entities and Methodology

(a) Using the above criteria, the accrual-based consolidated financial statements will include –

- Core Government funded by the GRA and Funds established under section 29 of the PFO, "Other Funds" created for meeting specified government purposes and predominantly financed by the Government (e.g. QEF), and the HKHA.

[7] Two methods of consolidation are used: line-by-line basis and equity basis. The former adds together like items of assets, liabilities, revenue and expenditure of the component entities and eliminating any inter-entity balances and transactions. The latter reflects the investment initially recorded at cost and adjusted thereafter for the change in the investor's share of net assets of the entities concerned.

They are to be consolidated on a line-by-line basis to fully reflect the financial performance and financial position.

- Government-owned corporations (e.g. MTRCL, KCRC and Airport Authority), Trading Funds and the Exchange Fund.

  They are to be consolidated on an equity basis to account for the costs of investments and undistributed profits.

(b) Entities which do not meet the above criteria should not be consolidated. Examples include –

- Hong Kong Housing Society (HKHS) – the Government has no ownership interest in HKHS and the statute does not contain any provision empowering the Government to revert the surplus of HKHS to the general revenue. As a non-profit-making organisation, HKHS is required under its constitution to apply its profits or other income solely in promoting the specified objects and to prohibit the payment of any dividend to its members.

- Hong Kong Export Credit Insurance Corporation (HKECIC) – although HKECIC is wholly-owned by the Government, the Government currently as a matter of policy does not participate in its profits/reserves which have since its inception been retained in the accounts of HKECIC to finance its business and activities as laid down in the relevant statute.

- Hong Kong Science and Technology Parks Corporation (HKSTPC) – although the Ordinance establishing HKSTPC contains a provision empowering the Government to revert HKSTPC's surplus moneys to the general revenue, the Government does not intend to participate in its surpluses/reserves which are to be retained by HKSTPC to finance its operations.

4.27 The flow chart at <u>Annex 12</u> illustrates the general principles and criteria for determining the boundary and methodology of consolidation.

4.28 It is noted that the IFAC standard stipulates a much broader scope for consolidation and requires that the consolidation be done on a line-by-line basis. The Treasury has expressed reservation to the IFAC, which has been largely endorsed by the HKSA, highlighting the impracticality of such an enormous scope of consolidation and querying whether a meaningful set of financial statements can be presented to users. The Task Force is of the view that it is more appropriate and pragmatic to adopt the above recommended treatment for consolidation in the Government's financial reporting.

## Departmental Service Cost Statement

4.29 In order to reveal the full costs of bureaux/departments in delivering their services, the Task Force recommends that a Departmental Service Cost Statement be published and included in the Government's annual accounts. This could help to focus attention on the aspects of cost which may be capable of being reduced. The Statement could also provide useful input for performance evaluation which may be used to highlight possible problem areas.

4.30 The Departmental Service Cost Statement (Annex 13) aims to present the full costs of a department comprising –

(a) Cash expenditure incurred directly by the department under its own Head of expenditure;

(b) Share of expenditure incurred in central Heads and Subheads (e.g. housing and other fringe benefits under GRA Head 46 – General Expenses of the Civil Service, court costs paid by the Department of Justice for the Government) – absorbed by the department based on actual or predetermined apportionment bases;

(c) Accommodation costs in respect of leased and Government-owned premises occupied by the department and its staff – based on actual rentals for leased premises, notional market rentals for Government-owned general office buildings and staff quarters, and annual depreciation charge for specialist buildings (e.g. police and fire stations) where the market rental basis does not apply;

(d) Accruing costs for pensions (including WOPS/SSCPS), earned contract gratuities and untaken leave of staff of the department – separately based on predetermined pension oncost rates, contract gratuity rates as specified in the contracts of employment and balances of leave earned but not taken;

(e) Depreciation of fixed assets (if the department owns fixed assets as defined earlier) – based on predetermined depreciation rates for the categories of fixed assets comprising infrastructure assets of Government Utilities which collect charges from consumers, and plant and equipment employed by the Government (please see paragraphs 4.18.3 and 4.18.4 above on the capitalisation of fixed assets); and

(f) Costs of services provided by other departments – based on rates of charges applicable to the public, full cost of the services provided or agreed prices.

## Inter-departmental Charging (IDC)

4.31 The Government's Financial and Accounting Regulation (F & AR) 435 states, inter alia, that except where special approval has been given, no charge will be made for services rendered by one department to another. F & AR 430 also states that fees may not be collected by one department from another, unless the provisions of legislation in any particular case read expressly to the contrary.

4.32 Currently, IDC arrangements are only in place for printing and transport services provided by the Printing Department and Government Land Transport Agency (GLTA) respectively. The said IDC is now implemented "above-the-line" i.e. spending departments make provision in their budgets for printing and transport charges and incur expenditure within the provision, while the service providing departments credit the revenue raised to Revenue Subheads.

4.33 Some other departments, however, undertake a central advisory or executive role to front-line departments and it is important when considering the cost of a service provided to the public, to take account of such contributions. Obvious examples are the Department of Justice and the Treasury where advice or system support is given free of charge but may constitute a significant element in individual service providing department's costs.

4.34 The Task Force considers that IDC is an effective means to help spending departments become aware of the costs of internal services consumed, which may prompt them to reconsider the actual demand for internal services and to explore other means to procure such services. The departments providing the internal services will also be under pressure to provide these services more cost-effectively and efficiently. The possible mechanisms for the implementation of IDC are discussed below –

(a) "Above-the-line"

This mechanism operates on a similar basis to that currently adopted by Printing Department and GLTA i.e. spending departments make provision in their budgets and incur expenditure within the provision, while the service providing departments credit the revenue raised to Revenue Subheads.

In arriving at the Government's total revenue and expenditure, the IDC transactions would have to be eliminated in order to avoid double-counting.

(b) "Below-the-line"

This mechanism would leave the existing appropriation and reporting arrangement intact but would add "below-the-line" (i.e. after the budget appropriations) a series of adjustments to reflect services acquired from other departments or provided to them.

By taking the adjustments out of the appropriation and control systems, they may be seen as being merely accounting entries and not "real" costs. The intended objective may not therefore be fully achieved, unless there is a strong policy direction and requirement to consider critically the "full cost" results shown in the departmental presentation.

4.35 To reap the full benefits of IDC, Controlling Officers should ideally have the autonomy to redeploy the resources subject to IDC (e.g. by employing alternative services and service providers including those from the private sector, etc.). This is because departments and bureaux to which charges under IDC are made may not feel that they should be held accountable for the costs incurred because they are not empowered to choose the service providers although they can, in some cases, reduce the volumes of the services required. Nevertheless, this does not preclude a phased approach, similar to that adopted in untying the services provided by Printing Department and Electrical and Mechanical Services Department, from being adopted in implementing IDC owing to the costs and impacts that may entail.

4.36 It is recommended that, as a start, IDC should be implemented on a "below-the-line" basis and should be limited to the 11 departments listed in Annex 14. Since costing exercises are already being carried out by these 11 departments annually to determine the Central Administrative Overheads (CAO) for services provided to other departments and bureaux, it would not be too difficult for these departments to refine, where necessary, the accuracy of their cost figures for inclusion in the Departmental Service Cost Statement.

4.37 A review should be conducted in three years after implementation to see if it is worthwhile to change the way in which IDC is implemented. In the course of the implementation, departments should be requested to identify the services provided to other government departments and bureaux that would lead to cost savings for the Government as a whole if charges are made for them. The timing and details of implementation of IDC will be dealt with in Chapter 6.

# Chapter 5 Conclusions, Recommendations and Consultation

## Overall Direction to Improve Government Financial Reporting

5.1 In the light of the deliberations as detailed in Chapter 4, the overall conclusions of the Task Force are –

(a) The existing cash-based accounts of the HKSAR Government should continue to be prepared in order to demonstrate the Government's compliance with the appropriations approved by the legislature and stewardship of cash spending.

(b) In addition to (a) above, it is considered equally important that the other four major reporting objectives as set out in paragraphs 3.2(b) to (e) should also be met by producing a set of accrual-based accounts which provides a fair presentation of the financial performance and financial position of the Government and demonstrates the resources employed by the Government in the delivery of public services. In endeavouring to achieve the objectives, however, a balance should be struck between the costs and the benefits involved, and take into account the needs and circumstances in the financial reporting of the Government.

(c) Given the scope, complexities and costs involved, a gradual approach should be adopted to improve the Government's financial reporting by setting priorities, formulating detailed proposals and implementing the recommendations step by step. The goal is to produce a set of Government Accounts that can enable the Government to achieve its financial reporting objectives as identified in paragraph 3.2 above and, as far as it is practicable, comply with gaaps including IPSASs.

5.2 Accordingly, it is recommended that the annual accounts of the HKSAR Government should in the future be published in two Volumes, and their respective bases of accounting and major purposes are –

(a) Volume I – prepared on the cash basis to demonstrate the Government's compliance with the appropriations approved by the legislature and its stewardship of cash spending; and

(b) Volume II – prepared on the accrual basis to fairly present the financial performance and financial position of the Government, and to demonstrate the resources employed by the Government in the delivery of public services.

The main features of these Volumes are outlined in the following paragraphs while the implementation plan and the resource implications are detailed in Chapter 6.

### Volume I of Annual Accounts of HKSAR Government

5.3 The recommended Volume I will be largely the same as the existing annual accounts of the Government except for some changes as set out below. The main features are –

5.3.1 Basis of Accounting

The accounts of the GRA and individual Funds established under section 29 of the PFO will be prepared separately and on the **cash basis** as they are now.

5.3.2 Reporting Boundary

(a) Similar to the existing arrangement, consolidated financial statements will be produced also on the cash basis but renamed as Core Government Account in order to distinguish it from the Consolidated Account published in Volume II as referred to below.

(b) The Core Government Account will include the Lotteries Fund due to the reasons set out in paragraph 4.26.1(b) above. As a result, the reporting boundary of the Core Government Account will include the GRA and all the Funds established under section 29 of the PFO.

5.3.3 Statements of Assets and Liabilities and Statements of Receipts and Payments

The format and style of the Statements of Assets and Liabilities and the Statements of Receipts and Payments of the GRA, individual Funds established under section 29 of the PFO, and the Core Government Account will remain unchanged.

5.3.4 Notes on the Accounts

In the Statement of Project Payments under the CWRF, the approved project estimate and the cumulative expenditure will also be shown to demonstrate that the cumulative expenditure of each CWRF subhead is within the approved project estimate.

5.3.5 Departmental Service Cost Statement

In addition to the above-mentioned Statements of Assets and Liabilities and Statements of Receipts and Payments, Departmental Service Cost Statement (Annex 13) will be prepared to reflect the full costs of resources consumed by individual departments and bureaux in delivering their services. This Statement will replace the Statement of Expenditure Analysis by Head and Subhead, currently published as a supporting statement to the GRA, and will present the full costs of a department comprising –

- Cash expenditure incurred directly by the department under its own Head of expenditure and compared with the amounts appropriated by the LegCo to the Controlling Officer of each Head and Subhead;
- Share of expenditure incurred in central Heads and Subheads of expenditure;
- Accommodation costs in respect of leased and Government-owned premises occupied by the department and its staff;
- Accruing costs for pensions (including WOPS/SSCPS), earned contract gratuities and untaken leave of staff of the department;
- Depreciation of fixed assets; and
- Costs of services provided by other departments.

It will also show the amounts recovered by charging out services provided to other departments and departmental revenue generated from fees and charges.

## Volume II of Annual Accounts of HKSAR Government

5.4 The recommended Volume II will contain –

(a) Consolidated Statement of Financial Position;

(b) Consolidated Statements of Financial Performance;

(c) Consolidated Cash Flow Statement;

(d) Notes on the Accounts; and

(e) Stewardship Statement.

A set of proforma financial statements are presented in Annexes 15 to 17 respectively for items (a) – (c).

5.5 The main features of the recommended Volume II of the Government's annual accounts are –

5.5.1 Basis of Accounting

Consolidated financial statements will be prepared on the **accrual basis**, subject to exceptions discussed earlier, to fairly present the overall financial performance and financial position of the Government and demonstrate the resources employed by the Government in the delivery of public services.

5.5.2 Reporting Boundary

The reporting boundary of the accrual-based consolidated financial statements will cover –

- Core Government funded by the GRA and Funds established under section 29 of the PFO, "Other Funds" created for meeting specified government purposes and predominantly financed by the Government (e.g. QEF), and the HKHA.

  They are to be consolidated on a line-by-line basis to fully reflect the financial performance of the year and financial position at the end of the year.

- Government-owned corporations (e.g. MTRCL, KCRC and Airport Authority), Trading Funds and the Exchange Fund.

They are to be consolidated on an equity basis to account for the costs of investments and undistributed profits.

5.5.3 Consolidated Statement of Financial Position

(a) The major types of **Assets** to be reported in the Consolidated Statement of Financial Position (Annex 15) are –

*Financial Assets*

- Cash and cash equivalents (e.g. bank deposits)
- Placements with the Exchange Fund
- Investments – subject to any provision for diminution in value, stated at cost or, for those investments consolidated on an equity basis, share of net assets
- Loans and advances
- Other financial assets and stocks in hand

*Fixed Assets*

- Infrastructure assets – represent the fixed assets of those Government Utilities with a significant part of their costs recovered from users (e.g. water supplies, sewerage services, toll-tunnels and bridges) – stated at depreciated historical cost or, if not available, at depreciated replacement cost
- Buildings, plant and equipment – stated at depreciated historical cost or, if not available, at depreciated replacement cost

*Net Assets of the Exchange Fund*

- Based on the total assets net of total liabilities and minority interests reported in the accounts of the Exchange Fund

(b) The major types of **Liabilities** to be reported in the Consolidated Statement of Financial Position (Annex 15) are –

- Provision for pensions liabilities (including the benefits payable under the WOPS/SSCPS) – based on periodic valuations by independent actuaries. Between periodic revaluations by external actuaries, the pensions liabilities reported at the end of each year can be adjusted by the amounts of actual pension payments and accrued pensions expenditure calculated in the manner described in paragraph 4.11.3(c) above

- Provision for contract gratuities – based on the gratuity rates of individual staff and salaries, and adjusted by the Government's MPF contributions
- Provision for untaken leave – based on the actual leave balances of individual staff and actual salaries
- Deposit accounts
- Government borrowings, if any
- Other liabilities

(c) The **Reserves** to be reported in the Consolidated Statement of Financial Position (Annex 15) are –

- General Reserve – represents the amount of net assets (total assets less liabilities) less (i) net assets of the Exchange Fund; and (ii) fixed assets
- Exchange Fund Reserve – represents the amount of net assets of the Exchange Fund whose use is governed by the Exchange Fund Ordinance
- Capital Expenditure Reserve – represents the cumulative amount of funds already spent on the acquisition or construction of those fixed assets recommended in paragraphs 4.18.3 and 4.18.4 above to be capitalised after deducting cumulative depreciation (i.e. net fixed assets)

5.5.4 Consolidated Statements of Financial Performance

(a) Two Consolidated Statements of Financial Performance will be produced to report expenses by –

- Nature (Annex 16-1) – grouping expenses according to their nature, e.g., staff costs, subventions and grants, social welfare benefits, capital expenses, depreciation, general operating expenses, etc.

- Function (Annex 16-2) – grouping expenses according to the policy area groups, i.e. education, health, social welfare, support, security, infrastructure, economic, environment and food, community and external affairs, and housing

(b) The major types of **Revenue** to be reported in the Consolidated Statements of Financial Performance (Annexes 16-1 and 16-2) are –

- Taxes, rates, duties and land premium income – recognised when they are received (i.e. same as the existing cash basis)

- Property and investment income

  On the sale of investments and disposal of properties, only the profit rather than the gross proceeds is recognised as revenue. In case of loss on sale or disposal, the amount of loss is recognised as expenditure.

  The interest cost on pensions liabilities discussed in paragraph 4.11.3(c) will be presented as a deduction from income from property and investment in the revenue side of the Statements of Financial Performance. This presentation is to reflect the fact that had a fund been set aside separately to match the amount of pensions liabilities, the income from property and investment would have been reduced accordingly.

- Net revenue from HOS/PSPS operated by the HKHA – gross proceeds less the construction costs and other expenditure related to the sales of HOS/PSPS flats as reported in the accounts of the HKHA

- Other revenue

(c) The major types of **Expenses** to be reported in the Consolidated Statement of Financial Performance – classification of expenses by nature (Annex 16-1) are –

- Staff costs – salaries and allowances (recognised on the cash basis) and accrued expenditure on pensions (other than the associated interest cost which will be presented as a deduction from income from property and investment on the revenue side), accrued contract gratuities and untaken leave

- General operating expenses, subventions and grants and social welfare benefits – recognised when they are paid (i.e. same as the existing cash basis)

- Capital expenses – expenditure under the CWRF and the Capital Account of the GRA, other than those capitalised as fixed assets, are recognised in the year of payment as capital expenses

- Depreciation – provided to spread the costs of fixed assets over their estimated useful lives so as to reflect the consumption of economic benefits embodied in the assets

(d) Expenses and the related revenue recovered from users are analysed by policy area groups in the Consolidated Statement of Financial Performance – classification of expenses by function (Annex 16-2).

(e) **Surplus/Deficit from operating activities** is the difference between revenue and expenses. **Share of profits and losses from equity investments** (i.e. those entities except the Exchange Fund consolidated on the equity basis) and **Surplus of the Exchange Fund** are then added to arrive at the **Surplus/Deficit for the year**.

5.5.5 Consolidated Cash Flow Statement

(a) Cash flows will be analysed by –

- Operating activities – activities that are not investing or financing activities

- Investing activities – activities that are the acquisition and disposal of long-term assets and other investments not included in cash equivalents

- Financing activities – activities that result in changes in the size and composition of the contributed capital and borrowings

(b) Receipts of non-revenue nature and payments of non-expenditure nature (see paragraph 3.3.2(f) above) can thus be segregated from those of operating activities and properly classified under investing or financing activities as appropriate.

5.5.6 Notes on the Accounts

The Notes on the Accounts will provide information on –

- Significant accounting policies
- Supporting breakdowns/analyses of assets, liabilities, revenue and expenditure
- Statements reconciling the fiscal results, the General Reserve and the Fiscal Reserve reported under the accrual basis and the cash basis (Annexes 18-1 and 18-2)
- Assets under the BOT arrangements – description of the assets and expiry dates of the relevant arrangements
- Land occupied by the flats under the HOS/PSPS and the TPS – in terms of (i) the numbers and the gross floor areas of the flats *sold* during the year or *pending sale* under the HOS/PSPS or TPS; and (ii) the cumulative areas of the land allocated for HOS/PSPS developments
- Land granted at a nominal or reduced premium to religious bodies, subvented organisations, etc. – the areas of the land granted in a year
- Commitments
- Contingent liabilities (e.g. litigation and guarantees provided)
- List of significant entities included in the consolidated financial statements

5.5.7 Stewardship Statement

The Stewardship Statement will provide narrative details of the following major types of physical assets in order to demonstrate the Government's accountability for the resources employed in the delivery of public services –

- Infrastructure assets such as roads and drainage (measured in terms of areas or lengths)

- Land and buildings used by the Government (measured in terms of areas and analysed by policy area groups)

- Land allocated for domestic rental housing developments – in terms of (i) the numbers and the gross floor areas of the flats *let or to be let*; and (ii) the cumulative areas of the land occupied by rental housing estates excluding the parts of the land occupied by commercial centres or carparks which will continue to be reported as investment

## Monthly and Quarterly Reporting of Financial Results and Position

5.6 The existing monthly financial results published in accordance with the International Monetary Fund's Special Data Dissemination Standard (see paragraph 2.12 above), and also the quarterly Consolidated Statement of Assets and Liabilities and Consolidated Statement of Receipts and Payments published in the Government Gazette (see paragraph 2.13 above) will continue to be prepared on the cash basis.

## Legal Implications

5.7 The Task Force's recommendations do not necessitate any amendments to the Audit Ordinance and the PFO as cash budgeting and cash accounting will still be used for the HKSAR Government and are supplemented by a set of accrual-based accounts.

5.8 There are, however, advantages to be gained from amending the relevant legislation to provide for the legal framework governing the preparation, audit and tabling of the accrual-based accounts. Since the recommended accrual-based accounts are in the early stage of development, it is considered premature to effect the legislative changes at this stage. This issue should be considered after the accrual-based accounts have been published for some time when their usefulness to and acceptance by the users (especially the LegCo) can be assessed. The review to be conducted in 2006-07 may be able to give a more specific recommendation on this issue.

## Audit of the Accrual-based Accounts

5.9 Discussions should be held with the Director of Audit with a view to agreeing on (i) an early target date for the formal audit of the accrual accounts; and (ii) possible early audit involvement, particularly during the identification and valuation of fixed assets, to ensure the bases being adopted for the preparation of the accrual accounts are sound.

## Consultation

5.10 In March 2000, a symposium on the Review of Government Financial Reporting was held to obtain the views of outside parties on the Task Force's preliminary deliberations. The event was attended by participants providing a broad representation of the accounting profession in Hong Kong including the President and the Council Members of the HKSA, the Members of the Public Sector Committee of the HKSA, the Director of Audit, and the accountancy academics from the universities in Hong Kong. According to their views, the emphasis of the Task Force should be to achieve substantive improvement through the inclusion of major assets and liabilities in the Statement of Financial Position, the reporting of full costs of service delivery and the consistent application of accounting policies. Changes should be introduced on a gradual basis and should be aimed at enhancing the stewardship and accountability of the Government.

5.11 In May 2001, the Task Force presented its review results to the Financial Affairs Panel of the LegCo and published its findings and recommendations for public consultation until June 30. The responses received are all supportive of the Government's initiative in introducing accrual-based accounts holding that they will improve the Government's cost-effectiveness, decision making, stewardship and accountability of resources, and that they will facilitate better understanding of the Government's financial performance and position. While there are views supportive of the Government's pragmatic approach in formulating its own financial reporting policies which are not entirely in compliance with IPSASs in certain areas, there are also other different views which can be grouped under the following three major categories –

- Higher level vision and final objectives: some commentators consider that the Government has not spelled out the higher level vision and final objectives of the proposed changes in the Consultation Document. They believe that accrual accounting should help in defining the role and scope of government and facilitating public sector reforms and that the HKSAR Government should strive to achieve these targets.

- Legislative framework and the co-existence of the cash-based and the accrual-based accounts: one commentator suggests that legislative changes should be introduced to formalise the preparation, audit and tabling of the accrual-based accounts so as to enhance the credibility of the entire financial reporting system. While the preparation of the second set of accounts on the accrual basis to better present the Government's financial performance and position is supported, some commentators are concerned that the different results and positions given by the cash-based and the accrual-based accounts could be confusing. They suggest that either there should be a single system unifying these accounts or that the accrual-based accounts be prepared alone. A few urge that the Government's budget should also be prepared on the accrual basis.

- Conformity to gaaps especially IPSASs: some commentators regard it as important for the accrual-based accounts to comply completely with gaaps in general and IPSASs in particular. Although they agree that it may not be practicable at this stage, they believe that the goal should be to move towards compliance within a definite timeframe.

5.12 The Task Force agrees that it should be the HKSAR Government's longer term aim to produce a set of annual accounts on the accrual basis conforming as far as is practicable with international accounting standards and gaaps. The Task Force believes that the production of such accounts will assist legislators and commentators to better assess the status and performance of the HKSAR Government and will also provide the basis for Controlling Officers to better understand and manage the resources being used to deliver the services for which they are responsible.

5.13 The proposals which are being made are the HKSAR Government's first steps towards these longer term goals and represent a pragmatic approach to obtain as much benefit as possible within a reasonable timeframe and at a reasonable cost. A post-implementation review will be made in 2006-07 to re-assess the costs and benefits of the implementation of the current proposals and take a view on the way to proceed thereafter.

5.14 The Task Force believes that, at least initially, it is necessary for both cash-based and accrual-based accounts to be provided. The cash-based accounts will demonstrate the Government's stewardship of the sums appropriated each year by the LegCo for the delivery of government services, while the accrual-based accounts will tend to focus attention on the costs of those services being provided.

5.15 The Task Force is aware of the dangers of confusion when presenting two sets of accounts but has undertaken to ensure that reconciliation statements and explanations will be provided to minimise the difficulties which may be experienced by readers.

# Chapter 6 Implementation

## Prerequisites for Successful Implementation

6.1 The Task Force considers that the prerequisites for successful implementation of the recommendations to improve the Government's financial reporting are –

(a) strong direction from the central government and support from the legislature;

(b) availability of sufficient resources for implementation; and

(c) acceptance by departments that this is a financial management reform aimed at improving each department's performance.

6.2 It is therefore important that briefing and consultation be made with the following parties before implementation –

(a) the LegCo;

(b) Heads of Departments and departments' finance officers;

(c) the accounting profession, particularly the HKSA and accountancy academics; and

(d) the general public.

## Recommended Implementation Plan

6.3 It is considered that the implementation should be on a progressive basis in order to allow departments sufficient preparation time for the more difficult tasks and to facilitate increased accuracy and sophistication of figures over a number of years. On this basis, the following implementation plan is recommended –

6.3.1 Phase I – Starting from the accounts for 2002-03
(Covering all the recommended changes except fixed assets)

- Implementation of all the recommended changes (as set out in Chapters 4 and 5) to Volume I of the annual accounts of the

Government except that depreciation will not be available until the completion of the identification and valuation of fixed assets in Phase II.

- Reporting of financial assets and liabilities in the Consolidated Financial Statements published in Volume II of the annual accounts of the Government together with analyses of expenses by functions (i.e. policy area groups) and by nature.

6.3.2 Phase II – Starting from the accounts for 2004-05
(Full implementation)

- Reporting of fixed assets (where the data of costs/values of fixed assets would be gathered and assessed by phases from the years 2002-03 to 2004-05) and supplementary stewardship information.

- Both IDC and Departmental Service Cost Statement will include depreciation.

6.3.3 Post-implementation Review

A review will be conducted three years after implementation (i.e. in the year 2006-07) to assess –

- The appropriateness of the format and style of the annual accounts of the Government particularly the usefulness and acceptance of the accrual-based accounts.

- The suitability of accounting policies and areas for greater conformity with gaaps including IPSASs particularly in respect of the accrual of revenue and expenses.

- The appropriateness of using the accrual-based financial accounting framework for budgetary planning, controlling and reporting.

- The need for legislative amendments providing the legal framework for the preparation, audit and tabling of the accrual-based accounts.

- The actual costs and benefits of IDC, the desirability of changing the scope of IDC, transferring IDC and other costs "above-the-line".

6.4 A summary of the major tasks involved in each phase of the recommended implementation plan is set out below –

| Phase | Major Tasks |
|---|---|
| Preparatory work (carried out during 2001-02) | • Briefing and consultation<br>• Planning and securing resources for implementation<br>• Formulation of accounting policies and guidelines and establishment of a Central Advisory and Support Team to monitor the implementation<br>• Staff training |
| Phase I (starting from the accounts for 2002-03) | • Valuation of financial assets<br>• Valuation of pensions liabilities (including WOPS/SSCPS)<br>• Valuation of liabilities for contract gratuities, untaken leave and other liabilities<br>• Preparation of Departmental Service Cost Statement which involves the calculation of accruing costs on pensions, contract gratuities, untaken leave and accommodation costs, ascertaining the costs of services provided by the 11 CAO departments (i.e. IDC), and apportioning expenditure in central Heads/Subheads to individual departments/bureaux |
| Phase II (starting from the accounts for 2004-05) | • All the tasks carried out in Phase I as listed above<br>• Identification and valuation of fixed assets and calculation of depreciation<br>• Identification and measurement of assets to be reported in the Stewardship Statement attached to the annual accounts of the Government |
| Post-implementation review (carried out during 2006-07) | • Review of various aspects as set out in paragraph 6.3.3 above in the light of the practical experience gained |

## Resource Implications

6.5 The implementation costs, comprising both start-up and recurrent costs, are assessed as follows –

(a) the one-off costs amount to about $49 million (of which $45 million is for identification and valuation of buildings) to be incurred between 2002-03 and 2004-05; and

(b) the average recurrent costs for the three years from 2002-03 to 2004-05 are expected to be about $9 million per annum with the costs mainly attributable to additional staff arising from the creation of a Central Advisory and Support Team in the Treasury and improvement in the costing systems among the 11 CAO departments recommended in paragraph 4.36 above for IDC implementation on a "below-the-line" basis.

6.6 The additional resources required should not be regarded as purely for the purposes of preparation and presentation of the Government's annual accounts because departmental management will also benefit through the provision of additional information for better management of the resources under their responsibilities.