

# **IMPACT OF IFRS ON AUSTRALIAN LOCAL GOVERNMENT REPORTING AND PERFORMANCE**

**Dr Robyn Pilcher  
Curtin University of Technology  
Australia**

**Professor Graeme Dean  
The University of Sydney  
Australia**

**Paper Submitted to the 6<sup>th</sup> Symposium on Accountability, Governance &  
Performance**

## **Correspondence Details**

Dr Robyn Pilcher  
Senior Lecturer in Accounting  
Curtin University of Technology  
School of Accounting  
PO Box U1987  
Perth WA 6845  
Phone: +61 8 92662879  
Email: [r.pilcher@curtin.edu.au](mailto:r.pilcher@curtin.edu.au)

**Key Words:** International Financial Reporting Standards, public sector, Australia, management decisions, interviews

**Acknowledgements:** This research has been assisted by The Institute of Chartered Accountants in Australia through its Academic Research Grant Scheme and The Sydney University School of Business Research Grant.

# **IMPACT OF IFRS ON AUSTRALIAN LOCAL GOVERNMENT REPORTING AND PERFORMANCE**

## **Abstract**

This paper considers the impact of International Financial Reporting Standards (IFRS) on management decisions by local government in Australia. Results indicate that although financial reporting requirements are time consuming and extremely costly, in larger councils they do not detract from management's operational decision-making. However, in small councils where resources and staff are scarce, complying with the various standards and legislative demands did appear to dominate management accounting systems. The research makes several contributions with results affording observations and precautions to users of financial statements as to what degree they can rely upon reported accounting numbers to assess performance.

## Introduction

In Australia in 1993, Australian Accounting Standard (AAS) 27 *Financial Reporting by Local Government* was introduced. Now, almost obsolete, this standard has been replaced by an International Financial Reporting Standards (IFRS) regime. Our evidence reveals that for local government, this has been a costly and time-consuming exercise – described by one interviewee as “a huge cost for no active gain”. This paper considers whether any additional reporting cost is worth the extra effort, especially if it means that local government is too busy complying and not spending enough time “doing”.

In 1987, Johnson and Kaplan’s much quoted work, *Relevance Lost*, argued that management accounting practices in US corporations had become subservient to the demands of financial accounting. Seeking to replicate the work, Hopper *et al.*’s. (1992) private sector pilot study found that managers of large UK public companies were primarily interested in financial accounting information because it was perceived to have had a major influence on how the City evaluated companies and their management. According to Joseph *et al.* (1996), which extended Hopper *et al.*, there is a large body of management accounting literature from which the relative effectiveness and relevance of cost accounting methods can be inferred, but which provide conflicting evidence. However, much of the 'evidence' was anecdotal, and hence Joseph *et al.*, conducted a formal study of organisations in the UK. Their survey found that there was little evidence of financial accounting dominating management decisions – however, some conflicting results existed. In the second phase of their project (published by Scapens *et al.*, 1996) – that including interview and case study data - no evidence was found that management reporting was subservient to the demands of financial reporting, or that management accounting systems were determined principally by external reporting requirements.

This study augments those works in several ways. First, it applies what, in the past, has been a private sector analysis to local government. Second, it determines to what extent, if any, financial accounting obligations dominate or significantly influence operational issues. This, in turn will help others, such as legislators and standard setters, to understand the pressures faced by entities which used to be considered ‘different’ but now fall under the same auspices as private sector entities. Third, it will assist councils to understand the impact financial reporting is having on other councils and if there may be ways (such as strategic alliances) of alleviating what is described as a “time consuming process”. The fourth contribution is that the research provides an insight into the internal and external audit processes of local government. Finally, the results afford observations and precautions to users of financial statements to what degree they can rely upon reported accounting numbers to assess performance.

Pilcher (2007) replicated the Scapens *et al.* survey, albeit in a different environment – that of local government. Results of the initial survey were mixed, and hence it was decided to extend the project by conducting interviews with a sample of responding councils. The paper begins with a brief description of the findings from the preceding survey project followed by a description of the councils interviewed. Then, like the Scapens *et al.* (1996) field study, results are presented in order to build a picture of local government reporting and its subsequent impact on management decisions. The project is enhanced by analysing the qualitative results statistically to determine any correlation between responses and council size or categorisation. This leads to consideration of the overall research question: “Does financial accounting dominate management decisions in local government?”

## **Background**

Local government in Australia is responsible for various community services such as infrastructure, waste, water, sewerage, parks and gardens to name a few. Responsible to both

the state and federal government, local government has come under pressure in recent years to financially “perform or perish”.<sup>1</sup> In 2004, Australia became one of the first countries to impose IFRS on local government with full compliance taking place for the 2005/06 financial year. Along with the adoption of IFRS, local government are responsible to the reporting demands of various legislative bodies, such as the Department of Local Government (DLG), the Grants Commission and the Australian Bureau of Statistics (ABS). These reports are often to be prepared in differing formats. As well, there is pressure from the NSW State Government as they require that, where appropriate financially, mergers, alliances or clusters be formed in order to create more efficiencies. However, by trying to create these efficiencies, councils are also aware they have to perform in a way agreeable to the DLG or risk being placed on a financial watch list.<sup>2</sup> As a result, many councils are struggling to find the status quo between financial reporting compliance and management decisions regarding issues such as infrastructure management. Therefore, this project was conducted to gain insight into the degree financial reporting is dominating management decision-making in local government. Initially it was conducted in Australia’s largest state, New South Wales (NSW). However, it is planned to extend this across all councils throughout Australia. The questionnaire and interview guide may then be adapted for use in other countries, such as the UK, in order to determine the relationship between financial reporting and managerial decision-making.

### **Description of Councils and Research Design**

In the initial phase of this project, a postal questionnaire was distributed to the Director of Corporate Services (or similar) in all councils of NSW in 2006. A response rate of 41% (63 councils) was achieved. Phase two considers a sample (16 councils, or 25%) of the original respondents who volunteered to be interviewed (refer Table 1). When compared to the percentage of firms interviewed by Scapens *et al.* (1996) – being 5% of original respondents –

---

<sup>1</sup> Quote by the Premier of NSW in his speech at the 2003 NSW Shires Association Annual Conference.

<sup>2</sup> Financial watch – defined as though councils having concerns with their financial operations (DLG, 2002, p.39).

this sample provides a sound indication of local government reporting practices. The councils interviewed ranged in size from small rural to large urban (refer Appendix 1). From the survey results a total of 46 follow-up questions were derived. Each council was then analysed separately and where survey answers differed from the overall mean a related question was included in the interview guide. Often answers were centred around the ‘neutral’ response, hence councils expressing a strong opinion regarding a survey question were investigated further. This allowed for more detailed answers to be obtained regarding views on the interrelationship between management accounting and external reporting, as well as the overall impact of IFRS in different decision contexts.

Table 1 provides background details for each of the case sites.

**Table I: Background to Council Case Study Sites**

Councils	Population of Council Area *	Australian Class'n (refer Appendix 1)	Local Govt Area (km <sup>2</sup> )**	Revenues (before capital grants) ***	Total Expenses from Ordinary Activities ***	Current Ratio	Debt Service Ratio
C1	37,791	URM	285	55,107,000	53,253,000	2.51:1	0.0644:1
C4	1,389	RAS	3,257	4,607,000	4,550,000	8.25:1	0.0294:1
C6	7,328	RAL	14,974	12,126,000	21,339,000	6.79:1	0.0001:1
C7	2,406	RTM	53,511	9,918,000	9,070,000	6.04:1	0.0108:1
C8	150,216	UFV	312	93,830,000	92,819,000	2.37:1	0.0289:1
C10	7,623	RAL	1,524	10,906,000	10,791,000	4.46:1	0.0674:1
C11	39,263	URM	3,428	56,600,000	61,734,000	4.85:1	0.0017:1
C22	3,520	RAM	2,895	6,803,000	6,944,000	6.70:1	0.0439:1
C23	36,630	URM	3,820	54,820,000	50,402,000	3.53:1	0.0656:1
C28	67,442	URM	1,175	94,441,000	76,015,000	5.32:1	0.2143:1
C30	12,074	RAV	4,994	21,429,000	20,204,000	4.02:1	0.0811:1
C40	108,697	UDL	86	66,560,000	65,744,000	1.75:1	0.044:1
C45	8,169	URS	130	10,798,000	10,518,000	5.75:1	0.0621:1
C52	192,402	URV	684	147,550,000	155,212,000	2.22:1	0.0214:1
C55	95,341	UDL	28	50,575,000	49,291,000	4.77:1	0.0609:1
C62	7,852	RAM	5,086	12,296,000	14,360,000	4.76:1	0.019:1

\* Population Source: <http://www.dlg.nsw.gov.au/dlg/dlghome/documents/Information/grants06.xls>

\*\* Source: [www.dlg.nsw.gov.au](http://www.dlg.nsw.gov.au) (24 December 2006) \*\*\* Source: Local council annual reports 2004/05

## Results

### General Views on the Impact of External Reporting

#### *Relationship between internal accounting and annual reporting*

Question 1 of the survey explored the relationship between internal accounting and financial reports prepared for the DLG. Respondents were asked to indicate their views on nine assertions by recording a score on a scale of 1 (strongly agree) to 7 (strongly disagree). Table 2 provides an indication of the overall mean response; the mean for interviewed councils as well as the strength of opinion for each assertion for those same councils.

**Table 2 Relationship between internal accounting and annual reports prepared for DLG (close-ended question)**

Question 1 Assertion	Mean for interview councils (15) *	% 1-3 for interview councils (15)	% 5-7 for interview councils (15)
a) Externally imposed accounting standards for annual reports prepared for the DLG influence council management decisions.	4.19	44%	44%
b) Internal accounting systems are designed primarily to provide information for annual reports prepared for DLG.	5.06	19%	75%
c) External auditors have significant influence on councils' choices of accounting policies.	3.44	63%	31%
d) External auditors have significant influence on the design of internal accounting systems.	4.56	25%	44%
e) Councils can influence the perception of their financial performance and position through their choice of accounting policies.	4.00	50%	44%
f) Councils on occasions change their accounting policies simply to influence stakeholder perceptions of performance.	5.56	13%	81%
g) Stakeholders can usually see through attempts to use accounting policies simply to improve annual reports prepared for DLG.	4.19	31%	38%
h) Internal accounting systems are designed primarily to meet council's management information needs independently from requirements for annual reports prepared for DLG.	2.56	75%	19%
i) Management decisions to allocate resources to particular activities (such as transport infrastructure decisions) are based primarily on internal accounting reports.	3.44	50%	38%

The sample mean was similar to the overall mean (63 respondents) for each assertion, being: (a) 4.41; (b) 5.11; (c) 3.97; (d) 4.81; (e) 3.46; (f) 4.92; (g) 4.43; (h) 2.79; (i) 3.79

From the survey, results indicated that internal accounting systems are independent to requirements for annual report preparation. The overall view of the interviewees was that the requirements of external reporting usually did not impact directly on management decisions.

Instead, financial reports were merely produced to comply with accounting standards and legislative guidelines. In NSW, councils are required to produce annual reports (including financial statements) and display them appropriately – either in council chambers, the local library or on the Internet. Typically, due to the complexity involved, respondents indicated that they believed very few, if any, were ever read by rate payers or councillors. Three representative interview responses were:

The annual report is 87 pages long – no one reads it.

Rate payers only refer to the management plan. Other than accountants, no one can make sense of the financial report.

The community don't look at the financials, only media headlines.

When tests were conducted on Question 1 to determine if there was any correlation between population and responses to assertions relating to the interrelationship between management accounting and external reporting, some interesting results prevailed.<sup>3</sup> A negative correlation for these assertions indicated that larger councils were more likely to agree with the claims than the smaller ones. This, in turn, could imply that these councils are using the accounting standards in their internal decision-making processes and have superior information systems which are designed to incorporate both. Consider the following interviewee observations.

Regarding Council C52 with a population of more than 190,000:

Accounting systems are built around internal reports but have codes that can be used for published financial reports.

Whereas, Council C4 which only has a total shire population of 1,389 had a different opinion:

External reports meet requirements of standards, code, legislation and regulation, whereas internal reports meet needs of council management for internal decision-making purposes.

Correlations were then examined between council classification (refer Appendix 1) and assertions contained in Question 1. Again a negative correlation implied that the urban

---

<sup>3</sup> Due to small sample size, tests were not statistically significant.

councils, which employ more qualified staff and have more resources, agreed with the relevant interrelationship assertions. The rural, more isolated councils perceived it is harder to cope with the constant legislative demands:

It is difficult to get qualified people to move to isolated areas and so it is very easy to get left behind.

Questions related to resource allocation provided some mixed responses and an interesting insight into other external pressures. 75% of interviewed councils agreed that allocation decisions were based on internal data, however, other factors involved in resource allocation included:

Political factors dictate – especially as there are hundreds of services to be provided – priorities require political choices.

Decisions are based on compromises between demands of councillors and ratepayers. However, it is the Minister who announces priorities.

Political interference means the DLG can change order of priorities.

These answers indicate that, although external standards may not influence management decisions, other outside influences – such as the actions of the Minister or the DLG – do. This, in turn, implies that *something* else may be a major factor in management decisions – if not external reporting requirements, then legislative demands and political pressure. Anything that detracts from an organisation's decision-making processes needs to be investigated further (a project for future research). It would appear that Gerboth (1973, p.479) was correct when he observed: “When a decision-making process depends for its success on public confidence, the critical issues are not technical; they are political ...”.

Debate in recent times has been associated with whether assets, such as transport infrastructure, should be included in the financial statements of local governments (for example, Pilcher, 2005; Walker *et al.*, 2004; Pallot, 1997). The impact of accrual accounting

on councils, both financially and physically, has taken its toll as they struggle to comply with differing and new standards - which now include IFRS. For example, one council stated:

We spend far too long complying rather than getting out and doing things ... Implementing IFRS meant we incurred an extra cost for no active gain. We prepared the relevant financial statements purely for compliance. We have more people reporting what they do than people actually doing things.

Therefore, even if it appears that external reporting is not dominating management decisions, it is reallocating time which could be better spent, according to interviewees, on operational matters.

### ***Financial performance and accounting policies***

Findings from Scapens *et al.* (1996) reveal that the flexibility offered by reporting standards meant there was adequate scope for managerial creativity with profits and losses being massaged and/or smoothed for the purposes of external presentation. The survey results reported in Pilcher (2007) indicated that 60% of respondents agreed that account preparers could use financial reporting to influence external parties. This, in turn, may indicate the potential for interaction between external reporting and internal decisions as, according to Joseph *et al.* (1996, p.81) "management will have an incentive to maximise and exploit the opportunity for flexibility in external accounting". Of the interviewed councils, 50% agreed in their survey responses that it was possible to influence the perception of their financial performance and position through their choice of accounting policies, however, of course most suggested "they did not". When interviewed, responses were somewhat more open with comments such as these:

It is possible to manage real estate development to provide a favourable result when it can, in reality, be a loss to the council.

Can twist numbers though depreciation.

It is very easy to change accounting policies to influence stakeholder perceptions of performance. For example, asset valuations, depreciation policy, useful lives. Easy to give assets all 100 years to reduce deficits.

It appears that depreciation is a vehicle for smoothing to influence outside perceptions of council performance (Hepworth, 1953). A major problem arises, however, if these figures are then used for any management decisions and the decision makers are unaware of the flawed data. As one account preparer who was interviewed claimed: “in the long run, this [manipulation] doesn’t help anyone”.

Some enlightening comments suggest that, consistent with the conventional wisdom on what affects performance, as noted (inter alia) by the Commonwealth of Australia Management Advisory Board (1977), what is specified in measurement systems influences the behaviour of those being measured: “... If you know you will be judged on certain results you are likely to change your behaviour to maximise performance in those areas ...” (1977, p.50):

Operating profit is targeted by the DLG and the Minister – losses seen as a problem.

We manipulate all ratios – including padding the capital ratio. The DLG has said “less than 10% is good for rates coverage” so this council ensures theirs is less than 10%.

If you know what the question is going to be you ensure your answer is right so as not to draw attention to yourself.

## **Impact of IFRS – Some Examples**

IFRS became a requirement for all Australian entities from 1 January 2005. While not all agree with this assessment, according to KPMG, there are many benefits of reporting under these standards, including (for the private sector) better financial information for shareholders and regulators, enhanced comparability, improved transparency of results, and increased capability to secure cross-border listing and funding.<sup>4</sup> For Australian local government, the IFRS were to be implemented in July 2005, with comparatives beginning July 2004. Again, opinions on the impact of these standards were varied and included anything from “minimal” to “time consuming”.

---

<sup>4</sup> [www.kpmg.com.au/Default.aspx?tabid=695](http://www.kpmg.com.au/Default.aspx?tabid=695)

Three major standards were determined by NSW local councils to have had the most impact on their published financial reports. The first was IAS 19 *Employee Benefits* which requires an entity to recognise:

- a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and
- b) an expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits (IAS 19, Objective).

In this context, the major change was to long service leave (LSL). With respect to superannuation, the Local Government Superannuation Scheme advised that it was unable to provide individual councils with an accurate split of their share of the scheme's assets and liabilities and so no asset or liability is currently recognised in local council reports.

The second standard providing councils with some problems was IAS 16 *Property, Plant and Equipment*. Under this standard, councils may need to recognise provision for remediation works to restore the environmental status of properties such as tips or quarries or for the dismantling or similar costs associated with such assets. Comments regarding both of these standards included:

The main impact [of IFRS] was on the current ratio as long service leave now recognised as a current liability.

Tip remediation – recognising a random liability as an asset is rubbish – it is a make believe number.

Employee leave entitlements are too subjective, therefore, we ignored the requirement to report them under IFRS.

In order to meet the objective of general purpose financial reporting, information provided in the financial reports needs to be useful to users for making and evaluating decisions about the allocation of resources and must possess the qualitative characteristics specified in the *Framework for the Preparation and Presentation of Financial Statements*. As such,

Australian Accounting Standards Board (AASB) 1031 *Materiality* provides the following guidelines:

General purpose financial reporting involves making decisions about the information to be included in general purpose financial reports and how it is presented. In making these judgements, considerations of materiality play an essential part (para.8)

Materiality is a matter of professional judgement influenced by the characteristics of the entity and the perceptions as to who are, or are likely to be, the users of the financial report, and their information needs. The following quantitative thresholds may be used as guidance ...

- a) an amount greater or equal to 10% of the appropriate base amount may be presumed to be material ...; and
- b) an amount less than or equal to 5% ... not to be material.

Consider the interviewee's claim that their council did not include any changes due to the implementation of IFRS as it was determined that changes were "immaterial".

We spent a lot of time going through IFRS but decided none were material. For example, rehabilitation of tips – when the council took over the land it was a bare hill with a hole at the bottom of it – it is still a hill and a hole in the ground, just a bit fuller.

However, it is not only the IFRS which are time consuming and thought to be a “waste of time”. Other external reporting requirements also meet with disparaging remarks from the interviewees, such as:

Schedule 7 [as required by the DLG] is a load of rubbish ... seen as important by DLG, yet figures are a farce.

Roads often referred to as a liability, hence, maintained not capitalised and depreciated.

Fair value of infrastructure will cause some problems – for example, three parks have been placed under ‘water’.

In this IFRS compliance context, McDonnell (2006, p.19) stated:

For an organization to cope, it will need to be moving toward a flexible approach where it is not just embedding reporting, but also embedding the ability to change. In any event, the only certainty for financial reporting in the coming years is that it will be a time of continuous change.

Financial reporting change is something local government has had to contend with for the last 13 years. For some, change is perceived as easy, with one council claiming: “IFRS is just a natural progression”. However, for others, change is not so easily accepted and hence external reporting requirements may have more of an impact on their daily operations. Whilst not explored here in any depth, some of this implied resistance to change may come from distrust of political and legislative bodies. Reasons for these responses will be explored as part of the ongoing research into local government.

Political issues drive accrual accounting.

The DLG will turn to financial data to achieve objectives.

We are driven in local government by political pressures.

The Scapens *et al.* (1996) monograph noted that interviewees were aware that the performance of their organisation was ultimately disclosed in their externally published reports. Therefore, they acknowledged a potential relationship between decisions at the operating level and group results. In local government, although (as indicated above), it is recognised that decisions made by external organisations are based on the published financial reports, these reports do not influence their operating decisions.

Lots of time goes into preparing financial reports, however, they are not used in council decisions.

We don't look forward using financial data – IFRS is more of a number crunching exercise than a value-adding one.

## **Stakeholders and the importance of financial information**

In the survey, Question 3 was included to determine the relative importance of four criteria (operating bottom line; financial key performance indicators (FKPIs); cash flow; and deviations from plan) potentially used for decision making by three stakeholders in three decision contexts. The overall results indicated that respondents regarded the information variables to have different degrees of importance for each of the stakeholders. Interviewees

were asked to explain their answers in more detail. Each council had its own ideas about which were the important indicators of performance. For management accounting, the community and non-financial indicators were often considered more important. Here, there appeared to be little, if any, interrelationship existing between financial reporting and management decisions. This is consistent with the literature, as according to Williams (1987), decision-making is inadequate as a principle for organising financial accounting practice because it does not recognise or explain the uncertainties caused by accounting. It also supports statements above revealing the possibility of smoothing being conducted by councils to improve external reporting results. Table 3 provides information regarding the ranking of the four variables by interviewed councils.

**Table 3: Relative importance of decision variables to DGL, Minister and Ratepayers\***

<b>Variable</b>	<b>DLG</b>	<b>Minister</b>	<b>Ratepayers</b>
<b>Reviewing Past Performance</b>			
Operating bottom line	2	2	3
FKPIs	1	1	1
Cash flow	3	3	4
Deviations from plan	4	4	2
<b>Deciding Future Strategy</b>			
Operating bottom line	1	1	2
FKPIs	2	2	3
Cash flow	3	3	4
Deviations from plan	4	4	1
<b>Assessing Current Performance</b>			
Operating bottom line	1	1	2
FKPIs	2	2	1
Cash flow	4	4	4
Deviations from plan	3	3	3

\* ranked by mean

Local government in Australia is judged on various performance measures, with the most important perceived (by interviewees) to be the operating bottom line and FKPIs. Each year the DLG releases comparative information to determine the best and worst performers. Interviewees stated that this publication influences external reporting decisions, but not operational ones.

We don't rely on FKPIs.

The bottom line is not important for council decisions – it is only an academic exercise.

Ratepayers only care about service provision, such as garbage collection.

Each interviewee was asked which stakeholder they perceived to be the most important. One more stakeholder was added to this exercise by respondents – elected councillors. Interviewees ranked the DLG and ratepayers as the two most important stakeholders (at 31% each) with councillors and the Minister ranking an equal second (19% each). Interestingly, even though ratepayers were ranked equal first, comments such as the following bring into question the validity of such a perception:

Ratepayers are the most important stakeholder. For example, there is currently a lobby group wanting a heated pool to be installed. Council has spent a lot of time addressing and listening to this group – even though it has every intention of *denying* them their request as there are no available funds.

It could be implied from this comment that, although councils are aware they need to portray rate payers as the most important stakeholder (after all, rate payers are responsible for electing councillors and providing councils with up to 8% of their revenues), in fact, this group of stakeholders are not respected as such. Of all the stakeholders, the political ones are still the ‘most feared’, with comments such as the following:

The DLG is the most influential stakeholder. It is a ‘master and servant’ environment. The council may not necessarily agree, but if the DLG says ‘do it’, you must.

The Minister is definitely the most influential stakeholder – he dictates most policies and edicts.

Association between council perceptions regarding stakeholder importance, council size and classification as rural or urban were considered. A positive correlation (significant to 0.1) was found between perceptions of stakeholder importance and the size of council (measured by population). Although not significant, a positive correlation also existed between stakeholder and council demographics. This could imply that the smaller rural councils perceive the political legislators to be more important than councillors or rate payers. Considering large

urban councils have more assets and, generally, more resources and qualified accounting staff than the smaller, rural councils, this is perhaps not surprising.

## **The Role of Auditors**

There has been very little written in practitioner or academic journals about the role of internal or external auditors in local government. Whilst not the major focus in this paper, some observations are nevertheless provided. With a discussion paper proposed by the NSW DLG regarding the introduction of internal audit committees into local government, it was considered pertinent to attain the viewpoint of the interviewees on what actually happened in the audit process.<sup>5</sup>

Council respondents had varying views on the role of the auditor. Nevertheless they agreed that the role of the external auditor is a constantly changing one, with more emphasis now being placed on corporate governance policies than relying only on the determination of an audit opinion. Some indicated that the external auditor played a major role in assisting with internal and external accounting systems and policies, whilst others observed that the auditor merely “ticked the boxes” and left the council to its own devices. In some councils respondents considered the auditors had too much influence on their accounting policies, whilst others enjoyed a good working relationship with their auditor. Consider the following:

Auditors only come in twice per year. They do not advise on accounting policies, nor do they have the right to do so.

External auditors can have too much control even if they don't understand the accounting policies – too easy to threaten qualification.

One year, I disagreed with the auditor who said he would qualify the report if I did not follow his advice. The council sacked the audit firm the following year.

We have a really good relationship with our auditors. Often contact them for advice.

---

<sup>5</sup> DLG (2005) Discussion Paper: “Internal Audit in NSW Local Government”

In 2001, the NSW Independent Commission Against Corruption (ICAC) found that 80% of general managers considered that internal audit function was important. However, the same research noted that only about 20% of councils had an audit charter, internal auditor or audit committee. This implies there may be a significant difference between theoretical and actual support for internal audit in councils. The DLG publicly asserts that internal audit should be given more prominence in NSW local government. To enhance the role of internal audit, the department is working to develop best practice standards to assist councils to put internal audit in place to an appropriate standard (DLG Circular, 05-33).

The interviews conducted sought to determine councils' opinion on the perceived benefits flowing from introducing internal auditors and/or internal audit committees. Again, council size appeared to be a factor in the responses received. For small councils the cost of employing an internal auditor was seen as too great and, usually, meant they were sceptical of any benefits. Some of the larger councils already had the process in place whilst others would be willing to consider the proposal if the cost could be met on a shared basis.

According to the Institute of Internal Auditors, internal audit is:

An independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes (<http://www.theiia.org/guidance/standards-and-practices/professional-practices-framework/standards/standards-for-the-professional-practice-of-internal-auditing>).

The DLG (Circular 05-33) has a dichotomous audit classification. One is a financial audit focusing on compliance with financial reporting requirements and accounting standards. The other is an operational audit – used to determine compliance with a council's policies and procedures as well as the efficiency and effectiveness of its programs or projects. However, our findings suggest that the exact role the internal auditor might play is problematic for

councils with some considering the proposed role likely to be a policy-based one, whilst others thought it would be similar to that of the external audit process.

We see the role as more procedural, as final checks and balances would only be duplication of external auditor work.

Internal auditors would have more of a policing role with regard to financial activity – for example, ensuring categorisation of expenses was correct.

Council already has a contracted internal audit team which reviews all auditable risk issues.

Could not afford an internal auditor – would make for costly checks. Would be better if shared between councils.

### **Discussion: Financial Reporting and Management Accounting**

For local government, the pain associated with implementing IFRS has only just begun. Implementation of fair value for all infrastructure is yet to occur, with this being staggered over a period of three years. Questions should be raised regarding the suitability of this requirement for local government. For example, consider accounting for council roads. How does one determine a fair value on an asset which, usually, is not sold and hence does not have an exit market value? Buildings represent another asset class, revealed by local councils, as potentially causing them some valuation problems under IFRS. Also problematic are investments – categorised as “income generating” something, according to interviewees, that is proving very subjective. These interviewees’ comments are apt:

Fair value of infrastructure will cause some problems, especially with respect to sector specific assets – roads, sewer and water. For example, we have placed three parks under ‘water’ – if the state government were to take over water and sewerage they wouldn’t know they were also getting ‘parks’.

Another issue relates to buildings which are owned by council and rented out. We had a local real estate agent value them, but income is not the prime purpose, therefore, they are not classified as investments.

This last comment begs the question as to whether investments provide another means for local government to manipulate or smooth data. Entities can use their own judgement when deciding how to classify items, such as rental buildings.

Finally, interviewees were asked if they had any further comments regarding the impact of IFRS on internal decision making. Their observations expressed several reservations:

IFRS is very time consuming and a waste of time "all airy fairy pie in the sky".

Fair value for infrastructure – makes life harder. For the majority of assets, it doesn't matter how you value them. What the theoretical depreciation and value is doesn't equal what council needs to do with them. What is important is how roads are maintained.

Traditional internal reporting standards create a barrier to the introduction of changes to external reporting standards as an internal reporting mechanism.

## **CONCLUSION AND FUTURE RESEARCH**

This project provides further insights into the impact of financial reporting requirements on management decision-making in local government. Views were sought from councils on the impact of IFRS and the importance of different types of information in different decision contexts. Unlike Scapens *et al.* (1996), no definitive answer was forthcoming. In general, the findings suggest that for larger councils IFRS do not detract from internal decisions. However, for smaller councils the time spent on complying with IFRS as well as various other legislative demands results in management accounting issues often being downplayed.

In regard to the role of auditors in the implementation of IFRS, generally the view of interviewees was that external auditors have not provided as much support regarding IFRS implementation as one might have expected. With respect to internal auditors, it is proposed that councils consider introducing them in some capacity. Views regarding their likely impact were mixed – due mainly to the expected costs associated with such a move.

Political issues still appear to dominate many of the financial decisions made by councils. This, in turn, provides a motive for manipulating or smoothing reported financial data – something councils perceive will persist even with the introduction of IFRS. Hence, one needs to be cautious when decisions regarding performance are being based upon such

figures. Future research will consider other factors, such as legislative demands and political pressure, which influence management decisions. As well, more analysis will be conducted to determine the impact external and internal audit has on local government financial reporting processes. This research will be conducted using a larger sample base – all Australian councils. This will then be adapted and extended to other countries, such as the UK and NZ.

## Appendix 1

### Australian Classification of Local Government and DLG Group Numbers

Step 1	Step 2	Step 3	Category	Alpha	DLG Group No.
<b>URBAN (U)</b>					
	<b>Capital City (CC)</b>	Not applicable	1	UCC	1
Popn > 20,000  or Population density > 30 persons/km <sup>2</sup> or 90% of LGS popn is urban	<b>Metropolitan Developed (D)</b> Part of an urban centre >1,000,000 and predominantly urban in nature	Small (S) up to 30,000	2	UDS	2
		Medium (M) 30,001-70,000	3	UDM	
		Large (L) 70,001-120,000	4	UDL	
		Very Large (V) >120,000	5	UDV	
	<b>Regional Town/City (R)</b> Part of an urban centre with < 1,000,000 and predominantly urban in nature.	Small up to 30,000	6	URS	4
		Medium 30,001-70,000	7	URM	
		Large 70,001-120,000	8	URL	
		Very Large >120,000	9	URV	
	<b>Fringe (F)</b> A developing LGA on the margin of a developed or regional urban centre	Small up to 30,000	10	UFS	6
		Medium 30,001-70,000	11	UFM	
		Large 70,001-120,000	12	UFL	
		Very Large >120,000	13	UFV	
	<b>RURAL (R)</b>				
	<b>Significant Growth (SG)</b> Average annual popn growth >3%, popn > 5,000 & not remote	Not applicable	14	RSG	N/A
	<b>Agricultural (A)</b>	Small up to 2,000	15	RAS	8
		Medium 2,001-5,000	16	RAM	9
		Large 5,001-10,000	17	RAL	10
		Very Large 10,000-20,000	18	RAV	11
	<b>Remote (T)</b>	Extra small up to 400	19	RTX	N/A
		Small 401-1,000	20	RTS	N/A
		Medium 1,001-3,000	21	RTM	9
		Large 3,001-20,000	22	RTL	10
		Very Large (V) >120,000			

Source for App. 1\_I: DLG NSW Local Government Councils Comparative Information 2001/02, [www.dlg.nsw.gov.au](http://www.dlg.nsw.gov.au) (accessed 1 December 2003)

## References

Australian Accounting Standards Board (AASB) (2004), *Framework for the Preparation and Presentation of Financial Statements*.

Australian Accounting Standards Board (AASB) 1031 (2004), *Materiality*.

Australian Society of Certified Practising Accountants, *Members' Handbook on Disk* (2002), Australian Accounting Standard 27 (AAS 27): *Financial Reporting by Local Governments*, June 1996.

Australian Bureau of Statistics, *Regional Population Growth, Australia and New Zealand, 2003-04*, Cat. No. 3218.0 as in NSW Grants Commission Table of FAGS to NSW Local Government Bodies - 1991/92 – 2005/06, <http://www.dlg.nsw.gov.au/dlg/dlghome/documents/Information/grants06.xls> (accessed November 2006)

Commonwealth of Australia, Management Advisory Board, (1997). "Beyond Bean Counting: Effective Financial Management in the APS - 1998 & Beyond", (Commonwealth Government).

Department of Local Government (2005), *Internal Audit in NSW Local Government*, Circular 05-33.

Department of Local Government (2005), *Internal Audit in NSW Local Government*, Discussion Paper.

Department of Local Government (NSW) (2002), *Annual Report 2001/02*, [www.dlg.nsw.gov.au](http://www.dlg.nsw.gov.au) (accessed July 2003).

Hepworth, S. (1953), 'Smoothing Periodic Income', *The Accounting Review*, cited in Hillier, J. and McCrae, M. (1998), 'The earnings smoothing potential of systematic depreciation', *ABACUS*, Vol.34, No.1, p.75.

Hopper, T., Kirkham, L., Scapens, R.W. and Turley, S. (1992), 'Does Financial Accounting Dominate Management Accounting - a Research Note', *Management Accounting Research*, Vol.3, pp.307-311.

Institute of Internal Auditors (2004), *Professional Practices Framework*, The Institute of Internal Auditors Research Foundation, USA. <http://www.theiia.org/guidance/standards-and-practices/professional-practices-framework/standards/standards-for-the-professional-practice-of-internal-auditing> (accessed December 2006).

International Accounting Standards Board (IASB) (2004), *IAS 16 Property, Plant and Equipment*.

International Accounting Standards Board (IASB) (2004), *IAS 19 Employee Benefits*.

Johnson, H.T. and Kaplan R. S. (1987/1991), *Relevance Lost: The Rise and Fall of Management Accounting*, (Boston, Harvard Business School Press).

Joseph, N., Turley, S., Burns, J., Lewis, L., Scapens, R., Southworth, A. (1996), 'External Financial Reporting and Management Information: A Survey of UK Management Accountants', *Management Accounting Research*, Vol.7, pp.73-93.

KPMG Australia (2006), *International Financial Reporting Standards*, [www.kpmg.com.au/Default.aspx?tabid=695](http://www.kpmg.com.au/Default.aspx?tabid=695) (accessed December 2006).

McDonnell, J. (2006), 'IFRS: Next Question: Is your Financial Reporting Sustainable?' *Accountancy Ireland*, Vol.38, No.2, pp.19-21.

NSW Shires Association (2003) *Annual Conference*, Wednesday 4 June, Parkes.

Pallot, J. (1997), 'Infrastructure Accounting for Local Authorities: Technical Management and Political Context', *Financial Accountability and Management*, Vol.13, No.3, pp.225-242.

Pilcher, R.A. (2007), 'Power Imbalances in Local Government – Interaction between Managerial Decisions and Prescribed Financial Reporting', *Paper to be presented at the British Accounting Association Conference*, Egham, April 2-4, 2007.

Pilcher, R. (2005). 'Financial Reporting and Local Government Reform – a (Mis)Match?', *Qualitative Research in Accounting and Management*, Vol.2, No.2, pp.171-192.

Scapens, R.W., Turley, S., Burns, J., Lewis, L., Joseph, N., Southworth, A. (1996), *External Reporting and Management Decisions: A Study of their Interrelationship in UK Companies*, (London: CIMA).

Walker, R.G., Dean, G.W. and Edwards, P.J. (2004), 'Infrastructure Reporting: Attitudes of Potential Preparers and Users', *Financial Accountability and Management*, Vol.20, No.4, pp.1-25.

[www.dlg.nsw.gov.au](http://www.dlg.nsw.gov.au) (accessed December 2006)