Budgeting and Accounting Issues - New Zealand

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Kevin Simpkins
Assistant Auditor-General
(Accounting & Auditing Policy)
Office of the Aucitor-General New Zealand

AND

Technical Advisor (New Zealand)
International Federation of Accountants'
Public Sector Committee

INTRODUCTION

It is both a pleasure and a privilege to participate in this Forum today to learn of the developments taking place in this and other countries and to share with you some of the developments which have taken place in New Zealand and some of the issues we face now.

During the course of this presentation, I will outline some of the developments in accounting and budgeting which have occurred in New Zealand in the past decade. I would also like to place those in a wider context of changes in public sector management. I will specifically cover the process by which accounting standards are established in New Zealand and conclude by discussing some of the issues which are providing us with challenges as we look towards the next decade.

My perspective on accounting and budgeting issues in New Zealand has been obtained from the perspective of an auditor and as one involved in the development of accounting standards. From 1989 until 1993 I was Technical Director of the (now) Institute of Chartered Accountants of New Zealand and from 1993 until 1995, National Director of Accounting with a major accounting firm. For the past three years I have had responsibility for the development of accounting and auditing policy within the Office of the Auditor-General.

NEW ZEALAND – SOME BRIEF BACKGROUND

New Zealand lies in the South West Pacific Ocean some 2,600 kilometres south east of Australia. It has a population of approximately 3.5 million, the majority of European origin. The indigenous Maori people comprise about 13% of the population. New Zealand's constitutional history traces back to the Treaty of Waitangi signed by the Maori and the British Crown in 1840.

New Zealand is a monarchy with parliamentary democracy. The Queen is the head of state of New Zealand and the Governor-General is appointed as her representative in New Zealand.

Parliament (the legislature) is the primary law making authority. Each Parliament has a term of three years, unless it is dissolved earlier. Historically, most Parliaments have run their three-year term.

The single House of Representatives has 120 members representing the people of New Zealand. In 1996 a mixed member proportional representation electoral system was adopted in place of the earlier "first-past-the-post" system. This has resulted in a coalition government since 1996.

New Zealand has no State governments and the role of local government is primarily the provision of urban and rural services that are paid for from property taxes, on both residential and commercial property.

The government is run by a Cabinet, comprising Members of Parliament belonging to the governing party (or coalition) appointed (depending on the governing party) either by the party caucus or by the leader of the party, the Prime Minister. Members of the Cabinet are known as Ministers.

Parliament has several select committees, chaired by backbench politicians. The Finance and Expenditure Committee is that Committee most directly involved in the public sector financial management system.

The public service is non-political. Heads of government departments are typically career professionals although appointments have been made from outside the public sector and from other countries, especially since the public sector reforms described below.

DRIVERS OF ACCOUNTING AND BUDGETING DEVELOPMENTS

Significant reforms of public sector management in New Zealand commencing in the 1980's were a response to much the same issues and concerns which have arisen in other countries. These include:

- Concern at the size of the government sector.
- A growing fiscal deficit.
- Desire for greater transparency and accountability in the provision of public services.
- Dissatisfaction with centralised input controls, established primarily through Treasury Instructions and the Public Service Manual.
- Dissatisfaction and frustration by Ministers that the existing system did not provide them with the information they needed for decision making. Neither was the public service responsive to their direction.
- Concern from Ministers about significant inefficiency in the public sector.

In essence, things needed fixing.
Under the old regime all public money was required to be paid into a consolidated bank account, managed and operated by the Treasury.
Departments were required to submit vouchers for payment to Treasury offices which organised payment, and the transactions were then reported in the "Public Accounts". The public accounts were cash based.
Budgeting was, in the main, limited to appropriations on a cash basis for loosely defined purposes or programmes.

LEGISLATIVE STRUCTURE OF THE NEW FINANCIAL MANAGEMENT SYSTEM

The theoretical influences on and bases for New Zealand's public sector management reform have been well documented by others(1) and are beyond the scope of this presentation.
Some of the key ideas influential in the reforms were:

- the separation between ownership and purchase interests;
- the separation between purchaser and provider;
- the distinction between outputs and outcomes;
- competition between service providers; and
- the need for clear specification of performance objectives.

Four major statutes provided the legislative vehicles for the new public sector financial management system.

The State-Owned Enterprises Act 1986 enabled the Government to transfer commercial operations into limited liability companies. These companies are governed by boards of directors and are charged with making a commercial return on the Government's investment. Over the years, a number of State-Owned Enterprises have been privatised.

The State Sector Act 1988 put in place different accountability relationships between departmental chief executives and their Ministers. Chief executives are appointed for fixed terms. Ministers are formally responsible for specifying the performance requirements of chief executives. Chief executives are in turn responsible for service delivery and have the necessary decision making authority delegated to them. In particular chief executives have effective control over the resources used to provide services. This means, for example, that all aspects of the employment of staff are delegated to them. Chief executives are the legal employers of their staff and are largely free to establish employment conditions as they believe most effective. There are no uniform collective pay scales across the public service. No central controls exist over purchasing practices. Chief executives of departments are responsible for the financial management of their departments.

The Public Finance Act 1989 restated the requirement for an appropriation by Act of Parliament for all expenditure of public money and determines the way in which Parliament votes appropriations to Ministers.
The Act specifies the reporting requirements of:

- the Crown (as a whole);
- government departments; and
- Crown entities (public bodies over which the Crown exercises control).

The reporting requirements of departments and specified Crown entities encompass both financial and non-financial dimensions of performance.
The Act requires the financial reporting by the Crown, departments and Crown entities to be in accordance with generally accepted accounting practice. This implicitly requires the adoption of full accrual accounting.
The Act also provided for a further shift in the focus of accountability towards what is produced (outputs) rather than what is used to produce it (inputs). Accrual appropriations for outputs replaced cash appropriations for inputs.
Full accrual accounting was achieved by all government departments by 1991. This was followed by the preparation of accrual financial statements for the government as a whole in 1992. In 1993 the whole of government reporting entity was extended to include State-Owned Enterprises and Crown entities. These entities are combined using the modified equity method. (Refer to the Current Issues section for a discussion of this policy.)

The Fiscal Responsibility Act 1994 sets out the principles for the formulation of fiscal policy in New Zealand. It requires the Government to publish regular statements of its short-term and long-term fiscal intentions. These fiscal strategy reports, as well as economic and fiscal updates, are required to be published at specified times and minimum disclosure requirements for these reports are set out in the Act.
The Act establishes five principles of responsible financial management. These are:

- Reducing Crown debt to a prudent level.
- Maintaining debt at a prudent level.

- Achieving and maintaining levels of Crown net worth sufficient to provide a buffer against adverse future events.

- Prudent management of fiscal risks facing the Crown.

- Pursuit of policies consistent with a reasonable degree of predictability about the level and stability of future tax rates.

The Government is required to disclose any departures from these principles. More detailed information on the reports required by the Fiscal Responsibility Act 1994 are set out in Appendix 1.

The overall effect of the ex-ante and ex-post reporting requirements is that accrual based information is the primary focus of all decision making and accountability at both whole of government and departmental levels.

In a development unrelated to the public sector financial management reforms, a Financial Reporting Act was enacted in 1993. This put in place mechanisms for a statutory accounting standard setting process to apply in New Zealand. Before this legislation came into effect on 1 July 1994, an amendment was made to the Public Finance Act 1989 (see above) to provide that the financial reporting requirements of the Crown, departments and Crown entities would be established through the same processes existing under the Financial Reporting Act 1993.

In essence, the various reports required to be prepared under both the Public Finance Act and the Fiscal Responsibility Act must be prepared in accordance with generally accepted accounting practice.

The term *generally accepted accounting practice* (GAAP) means:

- approved financial reporting standards (determined in accordance with the Financial Reporting Act 1993) so far as those standards apply to the Crown or the particular entity; and

- in relation to matters for which no provision is made in approved financial reporting standards and which are not subject to any applicable rule of law, accounting policies that are *appropriate* in relation to the Crown or the relevant entity <u>and</u> have *authoritative support* within the accounting profession in New Zealand.

A statutory body, the Accounting Standards Review Board was established to review and, if it considers appropriate, approve financial reporting standards submitted to it either by the Institute of Chartered Accountants of New Zealand ("the Institute") or any other person or body. The next section discusses the standard setting structures in more detail.

THE STANDARD SETTERS

The Institute's Financial Reporting Standards Board (FRSB) is the primary developer of financial reporting standards. It is assisted by a pool of volunteers who participate in working groups to deal with specific issues. The FRSB has responsibility for the due process resulting in the development of a financial reporting standard which it then submits to the Accounting Standards Review Board (ASRB) for approval.

Approval by the ASRB means that the standards have legal backing as they apply to the Crown, Government departments, Crown entities, local authorities, issuers of securities and to all companies except the smallest thereof. The ASRB also has the power to direct which policies have authoritative support (refer to the GAAP definition above.)

An important obligation of the ASRB is to liaise with the Australian Accounting Standards Board with a view to harmonisation of reporting requirements between New Zealand and Australia. A similar obligation exists in Australia.

Perhaps the most significant characteristic of the standard setting arrangements in New Zealand is that a common set of standards are established for entities in both the public and private sectors. Whereas some countries have in place specialised public sector standards, the approach in New Zealand has been to apply the same requirements in both sectors unless a specific issue justifies separate and specific treatment.

Another significant feature of the standard setting arrangements is that the Government has, in effect, excluded its own capacity to mandate and specify accounting rules for public sector reporting.

REPORTING OBJECTIVES AND SERVICE PERFORMANCE

The new public sector financial management system defines performance in different ways to previously. Three core notions have influenced that definition:

- the distinction between owner and purchaser interests;
- the importance of ex-ante specification of performance; and
- the distinction between outputs and outcomes.

The system adopted has been strongly influenced by the distinction between government’ s ownership and purchase interests. Performance from an ownership perspective normally involves achieving a desired return on investment, maintaining capital etc. On the other hand, a purchaser or customer is interested in whether the service was delivered as agreed or expected.

Because the two roles of owner and purchaser were normally exercised by a single Minister, the two dimensions of performance were not previously measured. The new system specifically addresses the purchase interest (referred to generally as "service performance").

The new arrangements place a strong emphasis on the ex-ante specification of performance. The arrangements were developed, in part, on the belief that performance assessment problems frequently result from inadequately specified objectives. Furthermore that ex-post evaluation is of limited use for accountability if the objectives were not agreed up front.

As noted previously a key element of the new public sector management system is a focus on outputs rather than inputs (as previously) or outcomes. Inputs are the resources (including capital, personnel, accommodation, equipment etc) used to produce goods and services. Outputs are the goods and services purchased by Ministers from public and private sector providers. Outcomes are the impacts on the community that provide the rationale for government action. A diagram illustrating the relationship between these three is set out below.

INPUTS Resources used to produce goods & services
OUTPUTS Goods & services produced by the agency
OUTCOMES Impacts on, or consequences for, the community as sought by the Government

A crucial element of the approach taken in New Zealand to outputs is that one party takes responsibility for delivery of the goods or services while another specifies the goods and services required. The Government decides its outcome priorities and which outputs it wishes to purchase to achieve them. Ministers seek appropriation from Parliament to purchase classes of outputs produced by departments or other suppliers (or otherwise to incur expenses, such as social welfare benefits). In relation to those classes of outputs to be purchased from departments, Ministers then contract for the supply of services from departmental chief executives whose responsibility it is to deliver those services as agreed. As noted earlier, chief executives have effective control over the resources appropriated by Parliament to produce these outputs.

In terms of the public reporting of service performance, the main Estimates presented to the House by the Treasurer on the day of the Budget set out the purpose (and other details) of appropriations sought by Ministers. They do this in a reasonably comprehensive way, including dimensions of quantity, quality, timeliness and cost of the services to be purchased. Departments are also required to present a Departmental Forecast Report which includes similar information to the Estimates and other information related to the Government's ownership interest. At the end of each year, departments are required to present a statement of service performance which reports their delivery of outputs as against the ex-ante specification of those outputs. Together with the financial information this provides a more complete measure of the performance of each department.

Those Crown entities in which the Crown has a purchase as well as an ownership interest are required to prepare, in addition to normal financial statements:

- A statement of objectives specifying the classes of outputs to be produced (as established at the beginning of the year).
- A statement of service performance specifying actual outputs produced

These statements are in practice normally presented as a single statement and report the extent to which the Crown entity has met its service objectives for the period.

The statements of service performance prepared by departments and Crown entities must comply with minimum requirements included within financial reporting standards under generally accepted accounting practice.

The Public Finance Act also requires that where outputs are purchased from entities which do not themselves table a statement of service performance in the House, Ministers are required to present a statement of service performance on the outputs within three months of the end the financial year. This is an attempt to ensure the completeness of service performance information provided to Parliament in relation to all of the Government's activities.

SOME CURRENT ISSUES

The reforms have been reviewed regularly over the past decade, both internally and by two independent reviews.

Most recently, in August 1996, an independent review of the New Zealand State Sector Management framework was completed by Professor Allen Schick.(2) This report concluded that the reforms had lived up to most of the high expectations held for them but identified three issues as warranting greater attention:

1. **Strategic Capacity**. (The Government's ability to make purposeful and directed change). The report found that the elements of the reforms, together with the more recent introduction of strategic results areas (SRAs) and key results areas (KRAs) have improved government strategic focus. However, Schick concluded that the current arrangements were still geared more to the short-term production of outputs than planning for the future.

2. **Resource Base**. (The ability to allocate resources efficiently.) The report identified a lack of rigorous costing systems as a hindrance to the establishment of prices in annual purchase agreements. It also made proposals to better align incentives within the system.

3. **Accountability**. While finding that the accountability aspects have been the most successful aspect of the framework, the report identifies that accountability requirements may be disproportionately burdensome for some small departments. The report also advocates the embracing of a "responsibility" model of accountability.

These brief comments give scant justice to Schick's comprehensive review of our reforms. Nevertheless, I believe the issues I have distilled are those which are relevant to my topic today. These issues are likely to be amongst those which form part of the further shaping of our public sector management system in the coming years.

In relation to departmental reporting, the Finance and Expenditure Select Committee of Parliament published a report in late 1997 on its *Inquiry into Departmental Reporting to Parliament*.(3) The Committee's key recommendations, accepted by the Government, were:

- That, where appropriate and possible, departments set out in their annual reports the relationships between their key result areas (KRAs) and output classes, and the Government's strategic result areas (SRAs) and desired outcomes.

- That departmental chief executives account for their stewardship of the Government's ownership interest in their departments in annual reports in order that select committees can evaluate the performance of departments from an ownership perspective.

- That the questionnaire previously completed by departments when subject to financial review by select committees should no longer be required. The key information is to be provided in annual reports.

I now turn to consider some more specific issues. They should be considered bearing in mind that accrual accounting is adopted for both budget and financial reporting purposes and furthermore that the ex-ante specification and ex-post reporting on service performance is on an output basis.

The Government Reporting Entity and the Method of Combination

The reporting entity for whole of government purposes comprises the core Crown, departments and Crown entities. In 1991 the Finance and Expenditure Committee considered issues related to the reporting entity and the appropriate method of combination.(4) It determined that Crown entities should be included within the reporting entity by specification on a schedule to the Public Finance Act. I should hasten to add that inclusion on the schedule was on the basis of specific criteria adopted by the Committee - criteria broadly consistent with notions of control as they would be applied in a reporting entity context for accounting purposes.

Both State-Owned Enterprises and Crown entities are combined into the Crown reporting entity using the modified equity method. This method was recommended by the Finance and Expenditure Committee in their 1991 report. In recent years there has been further discussion about the appropriate method. There seems little doubt that State-Owned Enterprises and the majority, if not all, Crown entities are "controlled" by the Government and following conventional notions of the reporting entity, should be consolidated.

The relevant accounting standard in New Zealand is Statement of Standard Accounting Practice 8: *Accounting for Business Combinations*, issued some years ago by the Institute of Chartered Accountants of New Zealand. The Crown has an exemption from the requirements of that Standard.

An exposure draft of a revision of SSAP-8 is scheduled to be issued in June 1998 and the Crown's exemption is likely to be removed.

The Controller and Auditor-General has supported the full consolidation of State-Owned Enterprises and Crown entities into the Crown Financial Statements and has expressed the view that full consolidation will result in a further improvement in the quality of information provided by the government's financial statements.

Recognition of Liabilities

There is little specific guidance on the recognition of liabilities in New Zealand. Greater clarity on the appropriate recognition point for liabilities is emerging in line with developments in standards in other countries. Specific areas in which greater clarity, and therefore greater consistency, has emerged are accounting for employee entitlements, provisions for maintenance, restructuring costs and other similar items.

Issues remain concerning certain obligations which the Crown has which are arguably of a non-reciprocal rather than reciprocal nature. The treatment of some of these items continues to be debated at specific entity level but are generally not material issues for the financial statements of the government as a whole.

One specific obligation has caused difficulty. It relates to future payments in respect of claims notified to and accepted by our Accident Rehabilitation and Compensation Insurance Corporation (ACC) in the current and previous years. The ACC is an insurance based scheme to rehabilitate and compensate, in an equitable and financially affordable manner, those persons who suffer personal injury. It is funded primarily by premiums from employers, motor-vehicle owners, earners and the Government (in relation to non-earners).

Obligations in relation to past claims, but which will not be met until future years, have not been recognised as a liability in ACC's financial statements nor in the financial statements of the government of New Zealand. This liability has generally been referred to as the "unfunded liability".

Within our reformed financial management system, the ACC is somewhat of an anomaly in that it employs a "pay-as-you-go" funding basis. Premium levels are set with the aim of providing cashflows sufficient to meet outflows in the current year. Most of the unfunded liability will accordingly be met by premiums to be paid in future years by various parties, most significantly employers.

In recent years the unfunded liability has been actuarially measured and comprehensive disclosures have been made in the financial statements of both the ACC and the Government. Recognition of the unfunded liability in the government financial statements would have a significant impact. The Crown Balance (assets less liabilities) at 30 June 1997 was $7470 million. Had the unfunded liability been recognised at that date the amended Crown balance would have been negative $797 million.

From a technical accounting perspective, it seems that the unfunded liability is a recognisable liability. The pay-as-you-go funding basis of the scheme is a separate issue that should not affect the question of liability recognition. A change seems likely in the near future to recognise the liability. It will be necessary at that time to ensure significant additional disclosures are made to reflect the fact that the liability will be largely met by premiums (in future years) from parties other than the Government.

Cost Allocation

Clear definition of outputs and effective cost allocation systems are very important.

Cost allocation systems developed in the early years were, however, fairly crude. This reflected a lack of experience and skill in such allocation systems. Progress has been made, but in my personal view much more remains to be done. Ken Warren, the Director Financial Reporting in the New Zealand Treasury has expressed the view(5) that progress has been hampered by the importance of living within appropriation. This has led to a demand that cost allocation systems produce a highly predictable amount rather than a result that is appropriately sensitive to changes in costing mixes.

As noted above, Professor Schick has also expressed the view that additional work must be done on costing of outputs.

Developments in Service Performance Reporting

The manner in which the distinction between outputs and outcomes has been given effect in the New Zealand reforms is discussed above. The rationale for the primary focus on outputs perhaps needs some further clarification. Those leading the New Zealand reforms recognised that outcomes provide the justification for Government intervention and are ultimately the measure of success. They had significant reservations, however, about the ability to enforce accountability of chief executives in outcome terms. Their reasons included problems in measurability, causality, control and timeframes. A decision was made that better performance would be achieved by focusing on those things which were able to be controlled.

My personal view is that the approach followed has been particularly successful. Nevertheless pressure remains for reporting about outcomes or at least about purchase mix decisions. Schick has raised this issue in his report "The Spirit of Reform". He has proposed that the purported causal link between outputs and outcomes should be diffused and that outcomes should be seen not as measures of impact but as indicators of direction. He suggests that particular outcomes may or may not be the product of outputs, but even when they are not, the Government should take notice of them, analyse the significance, seek to explain what has (or has not) happened, and develop appropriate policy responses.

The Finance and Expenditure Committee has also suggested in its "Inquiry into Departmental Reporting to Parliament" that "it would be worthwhile to encourage chief executives to include more reporting on the strategic issues and achievements in their annual reports". The Committee went on to observe that "…the way in which select committees interpret and respond to information from departments on strategic progress needs to acknowledge the fact that definitive judgements on cause and effect, credit and blame will seldom be either feasible or constructive. We are looking for a willingness by select committees to engage departments in conversation about what decisions are most likely to lead to the result desired by the Government and what are the most critical issues and challenges for those decisions to address."

The Institute of Chartered Accountants of New Zealand has also established a group to review the state of service performance reporting and it is expected that a discussion paper will be published in the middle of 1998 proposing further reform of this dimension of reporting.

Undoubtedly there is a need for, and expectation of, further developments in service performance reporting including addressing some of the issues raised above.

Other Issues

There are of course many other issues that continue to challenge us in our new environment. These include issues such as the appropriate accounting for infrastructural assets (primarily held by local authorities in New Zealand), revenue recognition policies (particularly where it is unclear whether a transaction is of a reciprocal/exchange nature or not), the appropriate accounting for heritage assets and other issues.

Life is not, and nor is it likely to become, boring for someone interested in improvements in accountability and in accounting and reporting issues.

CONCLUSION

Thank you for the opportunity of meeting with you and sharing some of our experience and the issues we are currently facing.

APPENDIX 1: REPORTING UNDER THE FISCAL RESPONSIBILITY ACT 1994

The Fiscal Responsibility Act requires information about specific fiscal indicators and forecasts over a three-year planning period to be published and updated at regular intervals. The following reports are required.

1 Budget Policy Statement

A Budget Policy Statement is to be published no later than 31 March each year. This is required to set out:

- Government's long-term fiscal objectives, and in particular Crown operating expenses, revenues and balance, and the levels of total Crown debt and net worth.
- Government's explicit intentions for the same key fiscal aggregates for the budget year and the following two financial years.
- Government's broad strategic priorities for the coming Budget.

The Government is required to assess the consistency of its fiscal intentions and long-term fiscal objectives with the principles of responsible fiscal management and previous Budget Policy Statements. It is also required to disclose any departures from the five principles of responsible fiscal management. It must specify the reasons for the departure, the approach that will be taken to return to adherence to the five principles, and the timeframe within which a return to the principles is expected.

2 Economic and Fiscal Updates

The Act requires the Treasury to prepare economic and fiscal updates at specified times:

- an economic and fiscal update at the time the Budget is presented;
- an economic and fiscal update published in December each year;
- a pre-election economic and fiscal update to be published generally four to six weeks before the day of each general election; and
- a fiscal update for the current year to be tabled with the Supplementary Estimates.

With the exception of the current-year fiscal update all updates must contain economic and fiscal forecasts for the three-year budget planning period.

Economic information provided is to include forecasts of movements in gross domestic product, consumer prices, unemployment and employment, and the current account position of the balance of payments. This information must be accompanied by a statement of all significant underlying assumptions. Fiscal information required comprises forecast Crown financial statements including a statement of financial position, an operating statement, cash flow statement and statements of borrowings, commitments and specific fiscal risks, together with details of all significant underlying assumptions.

3 Fiscal Strategy Report

This report is to be tabled in the House of Representatives at the time the Budget is presented, and must include:

- a comparison of the fiscal forecasts in the economic and fiscal updates with the Government's objectives and intentions set out earlier in the Budget Policy Statement;
- progress outlooks with projections of fiscal trends covering at least the next ten years; and
- a comparison of the progress outlooks with the long-term fiscal objectives set out in the Budget Policy Statement.

Inconsistencies between the Budget Policy Statement and/or the Fiscal Strategy Report and the immediately preceding Statement or Report must be explained and justified by the Government.

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Footnotes

1. *See for example Government Reform in New Zealand, Graham C. Scott, International Monetary Fund, October 1996 and New Zealand's Public Sector Management Reform: Implications for the United States, Graham Scott, Ian Ball and Tony Dale, Journal of Policy Analysis and Management, Vol.16, No 3, p.357-381, 1997.*

2. Schick, Allen: The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change. A report prepared for the State Services Commission and the Treasury, August 1996.

3. *Inquiry into Departmental Reporting to Parliament*, Report of the Finance and Expenditure Committee, November 1997.

4. *The Inquiry into Reporting by the Crown and its sub-entities to the House of Representatives,* Report of the Finance and Expenditure Committee, 1991.

5. Implementing Accrual Accounting in Government: The New Zealand Experience, International Federation of Accountants' Occasional Paper 1, December 1996.

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