Research Article

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The Use of Accrual Accounting in New Zealand's Central Government: Second Thoughts

Abstract: Business-style accrual accounting for governmental budgeting and financial reporting is widely promoted as appropriate for governments and promoted as successful in the countries that have already adopted it. There are, however, both constitutional and democratic reasons for close attention to their implications and effects. Accounting has a power of its own and, matters that “appear on the surface to be technical ... can be found to be intimately tied up with political, behavioural and constitutional concerns” (Pallot, 1991a). Drawing on the case of New Zealand, a leader in adopting these practices, this article notes the constitutional weakness of that country's fused executive and legislature and shows that the business-style governmental budgeting and financial reporting system have strengthened the executive government's powers over public finance. Unlimited power, without prior parliamentary scrutiny, is delegated to the Minister of Finance to conduct all borrowing, lending, investing and financial market activities. Public attention is directed to a fiscal target focused on net debt and thus deflected from the gross figures that reveal a pattern of increasingly leveraged public assets and deepening government immersion in capital markets. There is a danger that misunderstanding of business-style financial information by politicians and officials alike may lead to inappropriate policies and actions, and the inclusion of biases (known as incentives) in detailed financial rules that affect the financial reports increases that danger. With the direction of change in accounting standard-setting being to target sophisticated financial market analysts as the users of published financial reports, the likelihood that the “vast majority of readers will not understand [governments'] published financial reports” (Damant, 2003) carries with it constitutional and democratic implications that require further thought.

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1 Introduction: new public management reforms in New Zealand

New Zealand, a small island country of about four million people in the South Pacific, was a British colony from the mid-1800s until independence in 1906. It modelled its government on the British Westminster system, adopting a simple “first past the post” electoral system that operated until 1996. This electoral system, in conjunction with a unicameral government structure (single house of parliament) from the 1950s, meant that parliament was dominated by one or other of two main political parties. Major reforms could be

driven through parliament by the party in power, and New Zealand's economic restructuring and public sector reforms from the late 1980s are well known for the speed with which they occurred, and their comprehensiveness (Hood, 1991).

The New Public Management (NPM) style reforms pursued in New Zealand and elsewhere applied business principles and practices to governments. Financial management reforms to New Zealand's central government were legislated in 1989 and took effect from 1991. New Zealand led the world with some aspects of these reforms which included the adoption of business-style accrual accounting for both budgeting and financial reporting throughout the central government, a new approach to sovereign debt management, and non-financial reporting, that is, service performance reporting. Today, New Zealand has almost 25 years of experience of business-style accrual accounting at central government level.

That New Zealand's central government financial management reforms encompassed business-style accrual accounting made it easier to proceed quickly. The removal of various barriers to employment in the public sector, including salary barriers, facilitated the recruitment of qualified accountants from the business sector (Pallot, 2001). The decision to adopt business-style accounting also avoided the time and effort otherwise required to develop special accounting systems and practices. Difficult issues that arose when establishing opening balance sheets for government departments were in many cases addressed by removing problematic items from departmental balance sheets and taking them into the central government for Treasury attention. Just one among these issues related to establishing asset values for significant heritage items including national parks, buildings and protected species (Pallot, 2001).

A key feature of NPM reforms is the devolution of authority. In New Zealand, where the NPM reforms were Treasury-led, New Zealand Treasury officials' powers increased markedly. The new approach to sovereign debt management adopted within the Treasury from 1988 involved significant and increasingly devolved powers over public finance. Significant regulatory powers were also delegated to the Treasury, and Treasury officials also became influential in New Zealand's accounting standard-setting, thus helping to set the accounting standards with which the government's financial reporting practices must comply. The experience gained by some of those involved has contributed to international developments (Robb & Newberry, 2007). The development of International Public Sector Accounting Standards (IPSAS) was initially driven from New Zealand, and New Zealanders still seem to be influential in the ongoing development of IPSAS.

2 Second thoughts

Although the adoption of business-style accrual accounting for both budgeting and financial reporting in New Zealand's central government is widely regarded as successful, we should have second thoughts about some of the effects. Accounting has a power of its own and, "what appear on the surface to be technical matters – for example accounting and cash flow management – can be found to be intimately tied up with political, behavioural and constitutional concerns" (Pallot, 1991a). The speed and enthusiasm with which New Zealand's financial management reforms were pursued meant that more cautious voices, including Pallot's, might not have received the attention they warranted. Setting out some second thoughts here may serve as a warning for other countries that have proceeded more slowly with accrual accounting reforms. Four matters are addressed here: the key purpose of governmental accounting and the democratic implications; the accounting effect of some accrual-based accounting changes; the presentation and understanding of financial reports; and setting and developing accounting standards.

2.1 Key purpose and democratic implications

Historically, in the Westminster parliamentary system, public finance has been at the centre of the constitutional tension between parliament and the executive government. From this history, parliamentary control over and safeguarding of public money emerged as the paramount concern of public finance (Pallot, 1991b). That this is such a concern should be no surprise: a country's citizens must bear unlimited liability for government debt. In the event of government financial management difficulties the wider public suffers from increased tax imposition, loss of governmental services and in the case of government employees, loss of employment. The consequences of such difficulties became apparent most recently during the global financial crisis, and the effects continue today in Westminster countries (for example, the UK and Ireland) and non-Westminster countries alike (for example, Iceland and Greece).

The importance of these concerns should mean that any reforms to governmental financial management would be designed specifically for the constitutional conditions and concerns and, indeed, that the budgeting and appropriations process would be the starting point for reform (Legislation Advisory Committee, 1989). Accrual-based budgeting and appropriations were implemented from the beginning in New Zealand but determination to apply business-style accounting and financial reporting to government seemed to be the driving force. The budgeting and appropriations seemed to be an

afterthought, and it appeared that the “the tail (in other words the business style accounting and financial management system) was wagging the dog” (Jones, Lande, Luder, & Portal, 2013, p. 421).

The devolution of authority that is a feature of NPM reforms carries with it a tendency to shift the constitutional balance of power by weakening the legislature – parliament – while increasing and strengthening the executive government’s power. Historically, government budgeting has focused on controlling the receipt and payment of public funds. In Westminster parliamentary systems, the executive government’s presentation of its budget to parliament for appropriation implies submission to parliament’s constitutional power to control the executive government’s access to public funds. In practice, Westminster parliamentary systems allow the legislature (parliament) only relatively weak controls over the executive government (Leinert, 2005; Jones et al., 2013). In the absence of the checks and balances retained in other Westminster countries, such as an upper house, New Zealand’s Westminster system has become known as “a fused executive-legislature”, the weakness of parliamentary controls being “perhaps even unique among western democracies” (Parliamentary Library, 2011, p. 11). Accrual budgeting and appropriations have been hailed as a success in New Zealand, but the weakness of parliamentary control in New Zealand should be noted. In the US where the legislature’s constitutional power over the executive government is much stronger, accrual budgeting and appropriations were rejected as likely to undermine the legislature’s constitutional powers over the executive government (Leinert, 2005; Posner, 2007). The US has not adopted accrual appropriations.

Business-style accrual accounting as implemented for the New Zealand government’s financial management, accounting and budgeting strengthened the executive government’s powers over public finance, while further weakening parliamentary powers (Boston, Martin, Pallot, & Walsh, 1996; Newberry & Pallot, 2006). The key legislation, the Public Finance Act 1989, introduced and passed at speed, showed how a fused executive-legislature could produce “the fastest law in the West” (Palmer, 1979, p. 10).¹ The Public Finance Act 1989 includes the stated intentions to “provide a framework for Parliamentary scrutiny of the Government’s management of the Crown’s assets and liabilities, including expenditure proposals; and establish lines of responsibility for the use of public financial resources; and ... safeguard public assets by providing statutory authority and control for the raising of loans, issuing of securities, giving of guarantees, operation of bank accounts, and investment of funds.” However, it limits the appropriations system to expenses and some capital expenditure and

¹ Palmer, a constitutional lawyer, was New Zealand’s deputy Prime Minister until later in 1989 when he became Prime Minister.

delegates to the Minister of Finance unlimited powers over all borrowing, lending and investing activities without prior parliamentary scrutiny, while empowering the Minister to delegate further (see sections 50–53).²

In this reformed financial system, the Treasury, an agent of the executive government conceptualised as a corporate-style financial controller, holds extensive delegated powers of control over very large amounts of public money and public debt. The approach to sovereign debt management adopted within the Treasury from 1988 functions outside the budgeting process and therefore occurs without prior parliamentary scrutiny. While New Zealand's international leadership in adoption of business-style accrual accounting is well known, its leadership in adapting commercial practices to sovereign debt management is less well known (Horman, 2002). The portfolio and risk management techniques adopted, originally devised in commercial banks, rely on matching assets and liabilities, thus necessitating preparation of a balance sheet. The adoption of business-style accrual accounting has been central to this development in sovereign debt management (see Newberry (in press) for further explanation).

Horman (2002, pp. 8–10), who was involved in New Zealand's sovereign debt management developments, anticipated that, over time, financial assets would grow to dominate other assets and that the “new approaches to government-wide financial risk management” would allow the Treasury to “maximise the long-term economic returns of the government's financial assets and debt.” Gradually, this new approach to sovereign debt management has been applied more widely and has evolved into an investment function as well. Today it is applied to the whole range of assets and liabilities in the whole of government balance sheet and encompasses a policy objective to develop and support

² These delegated powers were extended in 2004 and today the Minister is authorised (without limit):

- to borrow on behalf of the Crown (s.47);
 - to appoint agents to conduct borrowing activities, who may in turn delegate their borrowing powers (s.50, 53) and those borrowing agents' activities are deemed lawful (s. 52);
 - to determine the terms and conditions of such loans and these are to be accepted as a charge on public revenues (s54, 55);
 - to issue and vary securities for money borrowed by the Crown (63, 64);
 - to enter into derivative transactions (s65G);
 - to lend money to others (s65L); and
 - to give guarantees or indemnities up to \$10 million (s65ZD).
- All payments to be made in relation to these financial activities are to be paid from public money (s55); and payments in relation to securities (s65D, E), derivatives (s65H) and guarantees and indemnities (s65ZG) must be paid without requiring further authorisation. The PFA also delegates to the Treasury the power to invest public money held in a Crown or departmental bank account and authorises all associated costs which must be paid (s65 I,J).

capital markets (see, for example, New Zealand Government, 2013). Government participation in capital markets is an important aspect of this capital market development objective, and the pattern apparent today is the leveraging of public assets (borrowing from capital markets to invest in capital markets) and deepening of government immersion in capital markets (see Newberry (in press) for further explanation). This leveraging has increased markedly since the late 1990s when various future obligations were highlighted as a policy issue and saving for such obligations by accumulating funds invested in capital markets became the preferred policy response (see Newberry (in press) for further explanation). Treasury policy discussion of the time viewed maintaining an ongoing government borrowing programme and involvement in financial derivatives as important for financial market participants (Claus, Jacobsen, & Jera, 2004). Although the social policy rationale is emphasised in most materials published for wider public consumption, the continued accumulation of financial investment funds might also be perceived as providing a means to absorb the government borrowing and other financial market activities. The resulting leverage increases the size (by increasing both total assets and total liabilities) of the Crown balance sheet which, as explained in New Zealand's most recent governmental financial management innovation, the Crown's *Investment Statement*, "has changed significantly in the last 20 years and will continue to change in the future. It will grow as the economy grows and, in particular, as holdings of financial assets increase as a result of governments' efforts to partly prefund the future costs of superannuation."³ Those assets will form a relatively greater proportion of the Crown's portfolio of assets over time" (Treasury, 2014, p. 3). Additionally, as the "composition changes the magnitude of risks the Crown faces will increase and their sources will likely change. ... In particular, the projected growth of financial assets the Crown owns will likely lead to increased operating and balance sheet volatility" (p. 118).

While there are undeniable benefits to be gained from devolving authority to unelected technocrats, the further disempowering of parliament that is associated with New Zealand's financial management reforms raises questions about the wisdom of such allowing extensive delegations and especially about the wisdom of delegating unlimited powers over borrowing, lending and investment activities. There is a need for attention to the balance of constitutional power over public finance and to examine more closely where the financial power of control lies in this reformed financial system.

³ New Zealand's government pays a small universal pension to those aged 65 years and over. In 2001, a special fund, known as the New Zealand Superannuation Fund, was created by legislation ostensibly for the purpose of pre-funding this pension.

2.2 Accounting effect of accrual changes

With power over public finance (borrowing, lending and investing) delegated and functioning independently of New Zealand's parliament, the accrual budgeting and appropriations system focuses attention on accrual-based revenues and expenses, and the resulting reported surplus (profit) or deficit (loss). While there is cash involved in these items, as with any accrual system the cash transactions are mingled with the effects of accrual-based journal entries and accounting policies. There appears to be an assumption that the reported accrual-based surplus or deficit affects the level of debt directly, but the budgeting and appropriations system pays little attention to such matters.⁴ There is a danger that misunderstandings of the financial information by politicians and officials alike can lead to inappropriate policies and actions, such as for example, reducing accrual-based expenses in the expectation this will automatically reduce the level of debt. Output expenses incurred by government departments include depreciation expense, so accrual-based expenses may be reduced by extending depreciation over a longer period. Similarly, the use of public private partnerships (PPP) instead of conventional asset procurements makes a difference to reported expenses and any reported surplus as well as to the perceived level of debt, but the accrual accounting anomalies associated with PPP can be deceptive and a considerable portion of the debt involved will be off balance sheet.

A further danger of misunderstanding arising from the accrual-based information comes from another of the intentions stated in the Public Finance Act 1989, to “establish financial management incentives to encourage effective and efficient use of financial resources in departments and Crown entities.” The thinking underlying one influential strand of the NPM theories in New Zealand is that the power to devise and impose rules is important and that biases (called

⁴ The principles of fiscal responsibility stated in the Public Finance Act 1989 and explained by the Treasury at the time are (www.treasury.govt.nz/publications/guidance/publicfinance/pfaguide/guide-pfa.pdf), p. 31:

- a) Reducing Crown debt to prudent levels, so as to provide a buffer against future adverse events, by achieving operating surpluses every year until prudent levels of debt have been achieved; i.e. the Government is to spend less than it receives in revenue until public debt is reduced to prudent levels.
- b) ... The principle is a two-tiered test; debt must be reduced and this must be achieved by running operating surpluses. This prevents governments from achieving prudent debt levels simply by selling assets.
- c) Maintaining total Crown debt at prudent levels by ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues; i.e. the Government is to keep debt at prudent levels by living within its means.

incentives) may be designed into those rules (Horn, 1995).⁵ The Public Finance Act 1989 delegated to the Treasury the power to establish more detailed rules than those in the legislation, and various biases since designed into the financial management rules at this more detailed level affect the financial results reported. Whereas lay readers of published financial statements may think that the published financial information tells the truth, the intention with incentives is to incorporate biases into the accounting rules and practices in the hope that the biases will prompt particular outcomes. The figures resulting from the application of these incentives are incorporated in the budgeting and appropriations process and in the published financial reports and therefore contribute to the decisions ostensibly made, or at least rationalised, on the basis of that published financial information.

Among the concerns arising from this incentives initiative is the manner in which it facilitates pursuit of a political objective (outsourcing of services and privatisation) by exaggerating the reported expenses and thus creating the impression of high and increasing costs of government services, causing misleading and unfair comparisons of governmental costs with nongovernmental costs. Newberry and Pallot (2004) provide several examples of these, including the intentional high biasing of a capital charge which then affected the cost of services. Accounting has long been known to influence people's thinking and behaviour (Hines, 1989). The biases added to the accounting rules as part of New Zealand's incentives projects demonstrate both awareness of that power to influence thinking and willingness to use, and misuse, accrual accounting for political ends. The dangers go beyond innocent misunderstanding of financial information because the incentives are intended to bias the information, and therefore seem intended to cause misunderstanding, at the very least among the wider public and opposition politicians.

2.3 Presentation and understanding of financial reports

Governmental financial reports today look like the financial reports of businesses. While those promoting the adoption of business-style accounting for governments do acknowledge that governmental financial reports should be interpreted differently from those of businesses, the starting point for understanding is knowledge of how to interpret the financial reports of businesses. Politicians and government officials do not necessarily have a strong business background that might facilitate such understanding – generally their backgrounds would be more diverse.

5 Horn was Secretary to the Treasury during some of these developments.

The level of understanding that accounting standard-setters expect of readers of business-style financial reports also requires thought. Although currently business-style financial reports are purportedly intended for a range of readers, accounting standard-setters have long held very high expectations of those readers' abilities, their familiarity with business and their financial literacy. Further, the current direction of change in accounting standard-setting is to view sophisticated financial market analysts as the targeted readers of published financial reports, thus increasing the likelihood that the vast majority of readers will not understand published financial reports (Damant, 2003).

The meaning of terms commonly used in accrual accounting – profit, loss, asset and liability – is seldom discussed, and many people think they know what these terms mean. Accruals-based financial reports are easily misunderstood, a common error, for example, being the assumption that a reported profit or surplus means an increase in money. Those from a business background know very well how easy it is to report an accruals-based profit even when a business is about to collapse from lack of funds. New Zealand's reformed governmental financial management system has resulted in a budgeting and appropriations process that focuses attention on revenues, expenses and surplus or deficit and encourages the assumption that these will determine the level of sovereign debt. Further, the fiscal strategy report and targets published with the budget emphasise net, rather than gross, debt and therefore de-emphasise gross debt and the leveraging involved to engage so deeply in financial markets. See for example, the long-term fiscal objective for net debt at 20% of GDP discussed in the 2014 budget papers (English, 2014, pp. 5–7). This focus deflects attention from the leveraging and financial markets activities that occur outside the budgeting and appropriations process, and thus undermines accountability.

2.4 Accounting standards

When New Zealand first adopted business-style accrual accounting for government, the business accounting standards applied in New Zealand were modified and claimed to be sector neutral – in other words equally applicable to both business and government. Although this initiative proceeded in New Zealand, the possibility of international application was controversial, and New Zealand's key reformers subsequently led the development of IPSAS, with the support of World Bank funding.

With the emergence of the International Accounting Standards Board (IASB), New Zealand, Australia and the UK urged the IASB to claim that its standard-setting activities apply to governments as well as to businesses (AASB, 2011). At the time, the IASB declined, emphasising that it devises its standards

for application to business entities involved in capital markets. When New Zealand, Australia and the UK adopted international financial reporting standards (IFRS), they applied a policy of “transaction neutrality” which meant the standards applied to government as well. In Australia and New Zealand, this meant including additional paragraphs in some standards to change requirements for government (see for example, in AASB116 *Property Plant and Equipment* at AUS para 15, three additional paragraphs AUS 15.1–AUS 15.3).⁶ More recently, New Zealand has moved to adopt IPSAS, the modified IFRS having been found overly difficult (Controller-Auditor General, 2008). The intention has long been that businesses and governments should follow the same accounting standards, and the IPSAS Board's declared strategy has been to converge its standards with IFRS (Robb & Newberry, 2007). IPSAS might be regarded as merely an intermediate step on that journey towards application of the IFRS to businesses and governments alike, rather than a development of accounting that is particularly suited to governmental accounting.⁷

The differences between IFRS and IPSAS should not be viewed as significant – both are aimed towards producing information for capital markets: stock markets and bond markets, including government bond markets. With the IPSAS tied to the IFRS, regardless of which of the two sets of business-style accounting standards governments adopt, they are allowing governmental accounting to be swept along with the IASB's direction of change to financial reporting standards and standard-setting. That direction of change seeks a “closer alignment of accounting and [capital] markets”, which will reshape financial reporting into a tool with which financial analysts in capital markets hope to predict an entity's future net cash inflows, and thus to price capital (Power, 2010, p. 208; Whittington, 2008; Biondi, 2011; Damant, 2013). Functions previously considered important in financial reporting, including stewardship and governance, are being abandoned because, as Damant (2013), long involved in international accounting standard-setting, has explained, these functions, although “vital, should not upset the aim of pricing capital, which would happen if the governance aim disturbed the correct approach to market efficiency adopted by the IASB.”

There are numerous specific concerns about the application of business-style accounting to governments, just a few examples including consolidation issues for whole of government reporting, the application of revaluation practices, the reporting of financial instruments and reporting of contingent liabilities. For whole of government accounting, how do we distinguish between

⁶ http://www.aasb.gov.au/admin/file/content105/c9/AASB116_07-04_COMPsep12_01-13.pdf

⁷ The IPSASB has claimed substantial convergence with IFRS since 2009 (IPSASB & International Public Sector Accounting Standards Board, 2009).

what is and is not government? Even if a concept other than “control” is applied to determine what to include, a decision to consolidate other entities involves such significant access to information by the executive government’s central agency (in New Zealand the Treasury) that its powers in relation to those entities are inevitably increased. If the bodies subjected to such increased powers are supposed to counter-balance the executive government’s power, the constitutional implications of whole of government accounting requires thought. With asset revaluations, the IASB has adopted fair value, widely interpreted as a selling price today. Whether it should be applied to heritage assets is debatable, especially in countries with a long history of civilisation. With financial instruments, mark to market requirements may have curious implications for government-issued financial instruments. Typically a government borrows at a lower than “market” corporate rate because of the sovereign guarantee. The question of what is a contingent liability and when its existence should be disclosed has long been difficult and is even more so in a government environment. During the global financial crisis, governments internationally accepted and imposed on their citizens and taxpayers liabilities that were not apparent before the crisis as they attempted to contain the crisis by supporting banks and other financial institutions. For those who bear unlimited liability for government debt, the consequences have been damaging, especially in some countries.

When governments delegate the power to set accounting standards, they delegate their own essential power to regulate. While there are undoubted advantages, especially in technically complex areas such as accounting standard-setting, the exercise of such delegated power warrants ongoing scrutiny. Further, there is scope for the use of such delegated powers to pursue political developments that would at the very least attract debate if parliamentary authority were retained. Here the old question of whether accounting standards are merely technical, or whether instead they are or can be inherently political (because of the critical socio-economic implications that lie behind apparent technicality), is crucial. This issue becomes an even greater concern when, having delegated the power to set accounting standards applicable to businesses, governments then agree to adopt the same, or substantially the same, accounting standards for governmental financial management and control.

3 Conclusions

New Zealand has long been part of the Anglo-American tradition of business-style accounting, and this tradition has been transferred into governmental accounting via the adoption of business-style accounting standards, whether

IFRS or IPSAS. The IASB's developments in that tradition are tightening the focus on accounting information for capital market participants and the implications are that few, other than sophisticated market analysts, will understand the published financial reports (Damant, 2003). For those countries previously outside this Anglo-American tradition of accounting, the adoption of accrual accounting in government financial management and reporting is a big step and yet the implications may not be so readily apparent. If governmental financial reporting is supposed to serve accountability purposes, the knowledge base of the readers of those financial reports is a crucial consideration. The constitutional and democratic implications are especially important, as are the socio-economic implications on management and reporting of the public service.

New Zealand's government financial management reformers worked extremely hard and subsequently became active and influential internationally in promoting those reforms, for example in IPSAS and in the IMF and World Bank. They and many in New Zealand's accounting profession are rightly proud of their achievements. But we should also remain aware that those achievements occurred in a Westminster system where parliament's control over the executive government is very weak and the reforms have weakened that control even further, while strengthening the executive government's and the Treasury's powers. The reformed financial management system is promoted using technical sounding language which on closer examination is also highly rhetorical.⁸ These reforms to the financial management system are bound up with constitutional, political and behavioural implications (Pallot, 1991a). Business-style accounting practices were not devised for the purpose of maintaining constitutional control and building potentially deceptive biases into the financial system as a means of pursuing political objectives the wider public might otherwise oppose is fundamentally undemocratic. If the control and safeguarding functions that have long been such a concern of public finance were to provide the starting point for accruals-based financial reforms, the chances are that neither IPSAS nor IFRS would be found appropriate. In the US, for example, the Government Accounting Standards Board (GASB) has long argued that governments have a "responsibility to be accountable for the use of resources that differs significantly from that of a business enterprise" and therefore that "governmental accounting and financial

⁸ See, for example, the Treasury explanation in Footnote 4; and the contrast between social policy rationales for wider public consumption that support growing financial market activity, as compared with Treasury policy discussion about ongoing governmental borrowing and involvement in derivative financial instruments as being important for financial market participants. Thanks are due to an anonymous reviewer for this point as well as for comment about the knowledge base of financial report readers.

reporting is – and should be – different” (GASB, 2006). There is a need to think further about approaches to governmental financial management and reporting that respects the need for constitutional control over public finance and offers financial reporting approaches that are appropriate given the importance of accountability to parliament and to the public for the stewardship of public funds.

While there are considerable benefits to be obtained from delegating control of complex matters to competent and technically qualified officials, we should still have second thoughts about the constitutional, democratic and behavioural implications of these developments in governmental financial management and reporting.

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