Federation of European Accountants

VIEWS

Accrual accounting: a key step toward better public finances

BRIEFING PAPER

HIGHLIGHTS

How can accounting help governments take the right financial decisions?

Complete and reliable annual accounts can improve financial decision and policy making for sound government finances.

Many Member States have already embraced accrual accounting but the discussion on its potential contribution to improving transparency and accountability is still ongoing.

This paper aims at highlighting some of the key benefits of adopting accrual accounting and its contribution to governments' financial decision-making process.

Introduction

The demand for sustainable public services, the pressure resulting from an aging Europe, as well as the increased spending on security, financial, and sovereign debt crises, has brought to light as never before the need for better financial reporting by governments and better management of public sector resources. Citizens increasingly feel the impact of governments' financial management decisions and are pushing ever more forcefully for public sector organisations to deliver value for money.

Governments face the current challenge of austerity combined with the long-lasting need to deliver public services with more efficient use of resources. Complete and reliable annual accounts[1] can help governments take the right financial and policy decisions for sound government finances.

Government accounting

What is accrual accounting? What is cash accounting?

- Under cash accounting, receipts are recorded in the period they are received and expenses are recorded in the period in which they are actually paid. In other words, recognising a cost/income only when cash changes hands.
- Accrual accounting requires that transactions are recorded when the underlying events occur, regardless of the timing of the related cash receipts and payments. In other words, recognising a cost when it is incurred and income when it is earned (cash information is also allowed while applying accrual accounting).

What is the situation in Europe?

Within the EU, accrual accounting is used more and more by national governments: 17 EU Member States already use accrual accounting[2]; several others are in the process of switching to it.

Member States generally develop their own country-specific rules for accrual accounting in the public sector. However, many of them refer to International Public Sector Accounting Standards (IPSAS) or national standards that are based on or in line with IPSAS (IFRS).

There are no harmonised EU-wide rules yet, but the European Commission is working on this and plans to issue European Public Sector Accounting Standards (EPSAS) within the next 4 years. In the meantime, the European Commission is encouraging Member States to switch to accrual accounting and potentially use IPSAS[3], which the Federation of European Accountants (FEE) sees as a pragmatic way forward.

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[1] The financial statements prepared by governments at the end of a financial year.
[2] For further information: http://www.pwc.be/en/publications/2014/epsas_oct_2014.pdf
[3] *EPSAS - How to achieve more reliable and transparent accounting systems*, https://polcms.secure.europarl.europa.eu/cmsdata/upload/bb67677e-a800-40e1-9d3f-f2cf97fcffad/brochure_epsas_final_011015.pdf

What are the benefits?

Using assets effectively

Accrual accounting requires complete recording of all assets[4]. As the use of public sector assets (for example, land, railroad tracks, public buildings, etc.) does not affect the current budgetary cost of public sector activities, it is often the case that assets remain unused for long periods of time even if they are located on land with high value in alternative uses[5]. By applying accrual accounting, policy makers are provided with transparent and reliable information on available assets as well as relevant information on assets' future use. On that basis, policy makers will be in a position to evaluate policy options and proceed with the most effective planning.

Managing liabilities

Accrual accounting provides a more complete picture of liabilities. Under accrual accounting, both financial and non-financial liabilities have to be reported in the annual accounts. This provides governments and stakeholders with a comprehensive and realistic picture of local, regional, and national liabilities.

Managing performance

Accrual accounting provides a more complete picture of costs for a specific reporting period. In order to achieve an effective performance assessment, one needs to have an overview of all costs involved; for example, the use of fixed assets, the costs of employee pensions or other benefits, etc. Under cash accounting, these costs are not recorded until the actual payment occurs or, alternatively, they would be recorded in the period of payment even if the costs are economically related to future reporting periods. Under accrual accounting, governments can obtain realistic cost figures and thereby assess the true performance of its public departments.

Addressing the citizens' right to know

As citizens increasingly feel the impact of their government's financial management decisions, there is a corresponding demand for reliable information to assess whether public services represent value for money. Accrual accounting is the best basis for providing this information, as long as it is published. There are several countries[6] in the EU and others around the world that are publishing their government's annual accounts, which is regarded as best practice.

[4] Assets need to be reported in accounts when the transaction occurs. The consumption of "service potential" (service potential indicates the capacity of an asset to provide goods and services in accordance with an entity's objectives) embodied in the assets also needs to be recorded via depreciation. This practice helps governments to evaluate their asset base and consider alternative use in the "asset disposal plan"; an aspect of particular importance in times of austerity.

[5] IMF Working Paper, *The Cost of Government and Misuse of Public Assets*, November 2000

[6] https://books.google.be/books?id=aUtWBQAAQBAJ&pg=PA307&lpg=PA307&dq=countries+publishing+financial+statements&source=bl&ots=oEdhoOrWXs&sig=1VZl8xje-y9kjKfZfIaU8dzImPQ&hl=en&sa=X&ved=0ahUKEwjHi-yI5cTLAhUGvA8KHSr5AScQ6AEINzAF#v=onepage&q=countries%20publishing%20financial%20statements&f=false

Improved Transparency

Greater information disclosure of government assets and liabilities is beneficial for investors in sovereign debt. Investors' appraisal of governments' financial and economic performance remains critical when it comes to interest rates requested for investing. There is evidence that countries which have adopted accrual accounting and at the same time are transparent about their complete asset and liability position are seen more favourably by sovereign debt investors[7]. Hence, adoption of accrual accounting could eventually allow EU Member States to benefit from lower rates on capital markets in the long term.

Improved comparability

The EU Member States are financially interdependent as never before. The different national economies are largely integrated and often the public sector represents a large share of the Member States' economies. Several decisions for national economic reforms are taken at Eurogroup[8] and Economic and Financial Affairs Council (ECOFIN)[9] level. Also, various EU economic governance initiatives (e.g. European Semester, six-pack[10], etc.) relate to budgets and macro-economic developments at national level. In the Eurozone, the European Central Bank (ECB) monitors members' inflation and other key fiscal indicators, while additional measures are being taken to further ensure sound public finances (e.g. two-pack). Finally, since the beginning of the financial crisis, a number of emergency loans have been granted to assist Member States in trouble.

All this has increased the need to compare EU Member States' financial position and performance. Cash accounts cannot provide an accurate picture because non-financial assets and liabilities do not appear in any statement at financial year end. As a consequence, comparison with the accruals based Member States' respective financial positions is hampered. This means that public sector financial accounting – and consequently performance measures – may lack a common denominator for comparison. By completing governments' accounts and by reducing variation of the reported information – which will result from harmonised accrual accounting – European policy makers would be able to achieve better benchmarking for assessing performance.

Saving for future generations

Member States face real challenges to achieve long term fiscal sustainability from an ageing population and the ongoing economic fallout from the latest recession. Governments have no choice but to improve the management of their resources in the long term. They need to ensure that future generations will be able to enjoy the same resources as previous ones and will not be overburdened with excessive liabilities. There is a need to focus on available assets, future commitments, expenses, and sources of revenue, rather than simply on cash flows. Accrual accounting can give a complete picture of governments' revenue and expenses, allowing them to initiate action at an early enough stage, thereby preserving assets for future generations[11]. The starting point is to use the right measurement tools, which can provide coherent information on public assets and liabilities.

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[7] IMF Working Paper, *Fiscal Transparency, Accountability, and Risk,* 7 August 2012

[8] The Eurogroup is an informal body where the ministers of the euro area member states discuss matters relating to their shared responsibilities related to the euro.

[9] The Economic and Financial Affairs Council (ECOFIN) is responsible for EU policy in three main areas: economic policy, taxation issues, and the regulation of financial services.

[10] Applies to 27 Member States with some specific rules for euro-area Member States, especially regarding financial sanctions.

[11] "Intergenerational equity": resources and assets (such as quality and diversity of environment) which do not 'belong' to any generation but are to be administered and preserved in trust for all future generations. http://www.businessdictionary.com/definition/intergenerational-equity.html#ixzz41x4tnXtL

Conclusions

Adopting accrual accounting will bring significant benefits to Member States as it has for business since centuries. It may be challenging for those Member States who are used to cash accounting However, experience shows that the paybacks will largely offset transition costs. Accrual accounting can contribute to long term planning and assist governments in sustainable decision making.

This is a critical time for Europe. Political leaders need to take important and forward-looking financial decisions for future generations. Public sector accounting needs to provide them with reliable financial information for short, medium, and long-term decisions.

Politicians and the public need to have complete and accurate financial information in order to be able to make the best economic and policy choices for today and tomorrow.

As expressed in previous publications, FEE would like to reiterate that public sector accounting standards should preferably be international to ensure that the EU remains attractive to global markets.

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Federation of European Accountants

WHO WE ARE

FEE represents 50 professional institutes of accountants and auditors from 37 European countries, with a combined membership of over 875,000 professional accountants working in different capacities. As the voice of the European profession, FEE recognises the public interest.

FEE is in the EU Transparency Register (No 4713568401-18).