



Fédération des Experts
Comptables Européens

THE ADOPTION OF ACCRUAL ACCOUNTING AND BUDGETING BY GOVERNMENTS (CENTRAL, FEDERAL, REGIONAL AND LOCAL)

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1. Introduction

- 1.1. There is an increasing tendency by governments at all levels to move to an accrual basis of accounting for financial reporting purposes with a parallel move to accrual budgeting, although in some countries the focus has been on accrual accounting only. To facilitate this governments have generally adopted accounting standards, either in the form specified by the IFAC Public Sector Committee (IPSAS) or by adapting private sector accounting standards.
- 1.2. The IFAC Public Sector Committee has substantially completed its first phase objective of producing a core set of standards based on International Accounting Standards (IAS). There are, however, a number of public sector specific issues, which are not covered by IAS, for which standards have not been developed. These include the treatment of tax revenues and social policy obligations. The IFAC PSC is now considering such issues and developing standards in the second phase of its project. However, until such standards are issued jurisdictions will need to determine approaches for these and other areas which are not covered by the IFAC standards. Governments will also need to develop accounting policies to apply those standards that have already been developed where there are both benchmark and allowed alternative treatments.
- 1.3. Whilst the profession welcomes the adoption of accrual accounting by governments as a positive reform the reform is also accompanied by a number of risks. Involving the profession in the process of governmental accounting reform in the ways that are set out in this statement would serve to lessen those risks.
- 1.4. Financial accounts can only provide one picture of the performance of a government or other public sector organisation. Increasingly other non financial performance information is being developed to supplement financial information. The adoption of accrual accounting will serve to strengthen the relationship between financial and non financial information.
- 1.5. For those countries that do not intend to move to an accruals basis of accounting, the IFAC Public sector Committee has recently published a 'cash standard'. This standard will result in improvements to the quality of cash based reporting and the profession should encourage the adoption of this standard to facilitate this.

2. Background

- 2.1. The underlying accountancy systems in the public sectors of most European countries are currently cash based. Therefore, where accrual based reporting is adopted using the standards developed by the IFAC Public Sector Committee, substantial changes will be needed to the cash based systems requiring detailed interpretation and application of the accounting standards (IPSASs). Without that detailed interpretation and application there is a serious risk that accrual based financial reports will not properly reflect the real impact of the underlying transactions.
- 2.2. Cash-based accounting has the virtues of simplicity and objectivity. These virtues should not be underestimated, particularly where as in many government organizations there are few, if any, skilled accountants (whether or not members of professional bodies) employed and where financial management is seen as of lesser importance than legal compliance. (The IFAC Public Sector Committee has also developed an International Public Sector Accounting Standard for the cash basis of accounting. Where governments have not decided to move to accrual accounting as a minimum, they should be encouraged to make the changes to their accounting arrangements to ensure that their cash based reporting is consistent with this Standard.)
- 2.3. However, the cash basis has significant weaknesses, not least because there is no matching requirement, information about assets and liabilities is frequently very limited and there is the lack of an effective balance sheet. Accrual-based accounting has the potential to produce more transparent and meaningful financial information. Whether or not this is of value, depends upon the capacity of the government to make use of it. This depends on the development of an understanding of the role of financial management and consequently of the infrastructure that can sustain financial management skills, not least, accounting training. In parallel with this there is a need to ensure that the public sector auditor is equally aware of the impact that accrual accounting can have, the risks that can ensue from its adoption and an understanding of the audit implications of accrual based accounting.
- 2.4. The accrual basis is a much more complex system than the traditional cash system. It requires a higher degree of judgment than the straightforward cash basis, particularly over valuations of physical assets and provisions. This can be both a weakness and a strength. This means that it is inappropriate for governments which do not have the expert resources capable of understanding the complexities of the system and also able to manage and maintain the more sophisticated accounting infrastructure. An external audit which is trained to audit accrual based financial reports is also an essential requirement. The adoption of accrual accounting would also be inappropriate in those countries which did not have a strong Ministry of Finance (or equivalent) with accepted authority over financial management systems and control and a neutral (non political) independent civil service.
- 2.5. The IPSAS have been developed by the accountancy profession (although there has been an involvement of others in the process) and in the application of those standards a number of important technical accounting decisions do need to be made. Yet in some European countries the following circumstances exist:

- The government sector contains few or no members of the accountancy profession;
- There is no systematic development of accountancy skills within the government sector;
- The public sector auditor is not trained in the use or interpretation of accounting standards;
- The laws governing the profession may actually make it impossible for a member of the profession to retain his/her professional membership and be employed in government service;
- There is no substantive role for the accountant (whether or not a member of a professional body) in the administration or management of public services and the role that the accountant can play in improving the financial management of such services leading to greater value for money, is not well understood. Financial management except in the sense of compliance with the budget is not seen as important.

2.5 What is more the International Financial Reporting Standards (on which the IFAC public sector and in turn country standards are based) are not designed to be prescriptive rules specifying in detail how transactions should be accounted for. The philosophy underlying international accounting standards is that they set a series of principles against which the decisions about the recording of particular transactions should be judged. The application and audit of such standards is based on the assumption that they will be applied by persons who have a thorough knowledge of accounting theory and practice and be audited by persons who have a similar background.

3. The benefits of accrual accounting for public services

- 3.1. There can be substantial benefits from the introduction of accrual accounting using the IPSAS, but these benefits are only likely to accrue where the appropriate conditions exist. The benefits include:
- Accrual based IPSAS accounts are more complete than cash based accounts and by definition they also remove the scope for the manipulation of payments and receipts in order to suit reporting and control objectives (although leaving scope for other forms of manipulation);
 - The information available from accrual based accounts facilitates a better quality of management and decision making including over the allocation of resources;
 - The opportunity to change organisational behaviour through the use of incentives and penalties including comparisons with the costs of the provision of services by the private and voluntary sectors;
 - The opportunity to establish effective performance measures that are not impacted by the vagaries of the timing of cash payments and receipts and which include information about fixed and current assets and liabilities;
 - The costs of capital assets are spread over the useful life of these assets;

- A more effective and reliable assessment of the financial health of the organisation.

3.2. However, these benefits can only be achieved where other conditions exist, not least the ability and willingness of the management to take advantage of the information available from accrual based accounts to improve the quality of the management process. Accrual accounting is not an end in itself.

4. Examples of particular accounting issues that need to be considered by governments adopting IPSAS based accrual accounting

4.1. Accounting standards developed for the private sector do not cover a number of items that are specific to the public sector. Examples of these are set out below and governments adopting accrual accounting will need to decide how to deal with the issues that they raise. There is no standard solution and different countries have adopted different solutions and even within a country there can be different solutions depending upon the level of government.

4.2. Clearly international benchmarking would be facilitated if there were standard solutions and such solutions may emerge over time. That, however, is not the current situation. Governments need to make decisions, which best suit their circumstances but those decisions should be intellectually coherent and stable over time. Some of the issues that need to be addressed include:

The Departmental or Agency Boundary: There may be differing views of the criteria that should apply to determine the departmental or agency boundary for consolidation purposes. Some may take the view that the boundary should reflect the head of the department's/agency's legal responsibilities; others would argue that it should be drawn more widely to reflect say *de facto* control. Or again other factors could be budgetary control and/or economic dependency.

Approaches to the recognition and measurement of property, plant and equipment: There can be disagreement about which assets to value, the valuation methodology, which valuation to adopt (e.g. current, historic or replacement cost) and how often to revalue.

Military Assets: Should military assets be capitalised and depreciated, or should they be treated as consumables? If they are to be treated as assets what life should they be given bearing in mind the rate of obsolescence of high technology assets.

Infrastructure Assets: Should infrastructure assets be capitalised and if so how should they be valued? Again, should there be a different treatment for the land (e.g. under roads), from the structures on that land? How often should infrastructure assets be re-valued and on what basis, for example the basis of current replacement cost depreciated to reflect the condition of the network.

Heritage Assets: Should heritage assets be valued and if in principle not, should a distinction be drawn for those that are used for operational purposes. What about newly purchased non-operational heritage assets such as works of art? Should they be capitalised in future (since the purchase cost is a reasonable proxy for valuation), even though say, the main heritage arts collections have not been capitalised.

Natural resources such as mineral reserves and forests: Are these to be included in the accounts and if so on what basis are they to be valued?

Depreciation: How should decisions be made about asset lives; should these be a matter for the asset user or should the Ministry of Finance specify what those lives should be? Should adjustments be made to depreciation schedules to reflect lack of maintenance or investment to prolong the asset life?

Environmental protection: Many activities cause damage to the environment and have the effect of incurring potentially large and long term liabilities. How far should an attempt be made to quantify such costs and when quantified how should such costs be accounted for?

Pension Liabilities: How should civil service pension liabilities be treated and should there be a difference depending upon how the pension scheme is financed? For example should they be treated as a deferred liability or charged to a department's expenses in the year in which they arise based on accrual cost or actuarial cost?

Capital Charging: Should departments be charged for the cost of capital employed, to include both fixed assets and working capital and if so at what rate?

Stocks: Which basis of valuation should be used? Should it be FIFO or average cost or some other basis?

Social policy obligations such as state pensions and social insurance: How should liabilities arising under these arrangements be treated? Should they be brought into the accounts or ignored on the grounds that the legislation affecting them can be changed and therefore that potential liabilities are not capable of measurement?

Revenues arising from non-exchange transactions such as taxes: When should tax revenues be recognised and what basis of measurement should apply? How should tax concessions be treated i.e. as a reduction of income or as an expense? What should be the treatment of estimated cost of tax evasion?

Provisions: What should be the circumstances under which provisions should be recognised? The recent tightening of the requirements about provisions contained in international accounting standards would make it more difficult for public bodies to 'hide' money for unexpected events or to 'smooth out' tax levels for electoral purposes. (This may also be a particular issue with guarantees.)

Public/private partnerships: How are the assets, liabilities, income and expenditure arising under these arrangements to be treated? How critical to the decision is the shift of the risk from the public to the private sector and who retains the ultimate control? (It is important to ensure that devices are not used to allow commitments to be moved 'off balance sheet' when the ultimate risk and control remains with the public sector.)

5. Risks with adopting accrual accounting standards based on IPSAS

- 5.1 Given these circumstances, the way in which accounting standards might be applied can lead to a number of potential risks which could seriously undermine the validity of the financial reports that are produced. These risks are reduced where certain preconditions are met before the accrual basis of accounting is adopted (these preconditions are detailed in the Annex to this paper).
- 5.2 What is more, because the IPSAS are principles based, a rigorous and independent approach is needed to the application and interpretation of those standards by the government sector. Yet national governments argue that they are sovereign and regional

and local governments often argue (with sometimes constitutional protection) that nothing should be done to fetter their discretion in administrative matters, including within that, the way in which their financial activities are managed and reported. The result is that there is a potential for substantial conflict between the principles underlying the application of accounting standards and the self interests of governments.

5.3 Therefore the move to accrual accounting carries with it a number of risks which could bring into disrepute the whole basis of accounting and through that lead to damage to the accountancy profession itself, the champion of accrual accounting. These risks are first, that:

- IPSAS are being, or could be, applied with no real understanding of the issues that are raised;
- the ‘gaps’ in IPSAS are not being, or might not be, properly addressed;
- IPSAS are seen as static, whereas in practice they are continuously evolving and a process is required to facilitate a disciplined approach to their evolution;

Therefore, governments adopting IPSAS need to recognise that the body of accounting standards will require constant development to address new and emerging issues and also that within the existing body of standards modifications will be required to reflect improvements that are being made to the IPSAS over time.

Secondly, there are other risks including:

- political pressure may cause decisions to be made about the accounting treatment of transactions in order to remove or minimise political criticism and this problem is accentuated as the dividing line between public sector and private sector transactions becomes increasingly blurred;
- the principles based approach leaves too much unfettered discretion to governments which the external auditor may be unable to prevent occurring and for which the Parliamentary process provides an inadequate check;

5.4 Thirdly, the cost and timescale that should be allowed to achieve the necessary changes to the underlying accounting systems should not be underestimated. The public sector has unique IT requirements caused by both size and the specialist responsibilities and activities of government.

5.5 There is the further point arising from the fact that in the public sector the budget is often seen as the key document. (The budget determines the allocation of resources between the public and private sectors, determines fiscal policy and the distribution of the taxation burden, allocates public resources between the different expenditure programmes and may also provide the legal authority for expenditure.) This point is that where the budget remains framed on a cash basis and the accounts are maintained on an accrual basis this could make the process of financial management and expenditure control that much more difficult, because of the systematic adjustments that have to be made. Clearly where both the budget and the financial reporting are prepared and maintained on the same basis there is a lesser risk of a loss of financial control. Therefore where countries have taken the decision not to switch to accruals based budgeting, particular attention should be paid to the problems that might arise from the different bases of the budget and the accounts.

6. Setting accounting standards for government based on the IPSAS

- 6.1. Where governments decide to adopt accrual accounting a crucial decision has to be made about how the accounting standards should be developed and their application monitored. There ought to be a significant role for the accounting profession as the 'guardians' of accounting standards.
- 6.2. Therefore an essential element where IPSAS based standards are to be applied, is co-operation by the accountancy profession in the development of those accounting standards for the public sector. The profession ought to become involved in the application of those standards and the monitoring of their implementation. Without that independent involvement the effect would be that the government could be seen as setting its own accounting standards and applying them in a manner that suited the political circumstances of the moment. That would damage not only the credibility of the process but in the end would mean that the disciplines that accrual accounting and budgeting are meant to achieve could not be established.
- 6.3. Therefore independence of the standards adopted with a critical appraisal process is essential, even though such an approach might be potentially uncomfortable for the government,. Given the need for transparency and independence governments should not be able to argue that they are sovereign and/or that nothing should be done that fetters their discretion to decide how accounting standards are to be applied.
- 6.4. However that also means that the accountancy profession must have a capacity to both understand the nature of the public sector, to recognise that circumstances are different from those of the private sector and that comment, when made, has to be made and clearly made from a politically disinterested perspective.
- 6.5. There is no one model for professional involvement in the standard setting process. However what are crucial are the following:
 - That there is an independent Committee or Board established to agree the application of the standards to government;
 - The Chairman of the Committee or Board is independent;
 - The Committee or Board includes representatives from all the affected groups, including the Ministry of Finance, the government auditor and the accountancy profession;
 - That the Ministry of Finance is required to submit to the Committee or Board any decisions affecting the application of accounting standards or the modification of any previous decision;
 - That individual standards are published as are any departures from international standards;
 - That an annual report is published and submitted to Parliament.

7. The conditions that ought to exist before accrual accounting is introduced into the government sector

7.1 The decision by governments to switch to accrual accounting should not of itself be regarded as either desirable or appropriate unless a number of key conditions exist. These key conditions are set out in the annex to this statement.

7.2 These key conditions need to exist to ensure that the reform is not only technically successful, but that it facilitates an improvement in the quality of public sector financial management and increases the independence and transparency of the financial reporting process. The conditions cover the following:

- *Consultation and Acceptance.*
- *Participation of the Accountancy and other Professions.*
- *Joint Development of Accounting Standards.*
- *Support of the Government Auditor.*
- *Comprehensive Management Training.*
- *An appropriate cultural approach.*
- *A robust audit process.*
- *No corruption.*
- *A recognition of the elapsed time needed.*
- *An IT capacity.*
- *A willingness to use incentives and penalties.*
- *That the accrual approach is part of a process of reform.*

8. The accountancy profession and other factors affecting the public sector

8.1. The involvement of the profession in the setting of accounting standards on its own is insufficient to achieve success in the application of accounting standards to the public sector. As has been shown above, other conditions are of importance, not least the technical accounting capacity of the government sector itself. Where the profession is not involved, then the only source of training is the universities and whilst that may be adequate it is unusual for university courses to focus on the accounting needs of the public sector and in many countries it is also unusual for the public service to regard an accountancy degree as a route to preferment with priority being given to law and economics graduates. The introduction of accrual accounting changes this because it requires the availability of a cadre of accounting skills.

8.2. Therefore, where governments decide to introduce accrual accounting the profession should be prepared to open a dialogue with governments about the total process and particularly about the availability of professional accountancy skills. The profession should encourage governments to give at least equal weight to accountancy degrees and/or to professional accountancy qualifications as a preferred discipline and it should

point to the need for a skilled cadre of accountants within the government sector able to interpret and apply accounting standards and exercise appropriate financial control.

9. Conclusion

- 9.1. The change to accrual accounting does have the potential to produce significant benefits not only in the quality of financial reporting but also in a greater ability to bring together both financial and non financial performance information. This should lead to a better quality of financial management, improved efficiency in the use of public sector resources and a more informed user of the accounts, all of which in turn add value to the democratic process.
- 9.2. However, the introduction of accrual accounting by governments based upon the IPSAS whilst generally a development to be welcomed by the profession carries with it risks to the integrity of the financial management process within governments that the profession should recognise. It also carries with it responsibilities for the profession which the profession ought to be prepared to take on and which if taken on will serve to lessen the risks to financial integrity that could exist.
- 9.3. The profession is the guardian of international accounting standards and it is for the profession to ensure as far as it can that the integrity of those standards is protected.

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Annex

The conditions that need to exist before accrual accounting based upon the IPSAS is introduced by governments

The following paragraphs set out the essential conditions for success in the introduction of accrual accounting.

1. *Consultation and Acceptance.* To be successful, the organisation needs to be prepared culturally for its introduction and be willing to recognise and accept the benefits that the changes will bring about and the costs of implementation in their widest sense. The pre-consultation exercise within government departments and the public consultation exercise are important preconditions for success. Another prerequisite is a willingness by the civil service to accept that the reforms would change the role of those responsible for financial management in government, significantly changing their influence and responsibilities. Acceptance has to go beyond a relatively narrow group of technocrats.
2. *Participation of the Accountancy and other Professions.* A complementary precondition is that the accountancy profession is prepared to be interested in and involved with the public sector because not only is the accountancy profession the expert in accounting standards but it has traditionally trained financial managers for the private sector. To be successfully implemented and operated, the reform requires not only an increase in the number of financial managers (who may or may not be qualified members of a professional body) employed by government but an acceptance of their contribution to the efficient and effective management of the public services. There also needs to be a willingness to meet the financial management education and training requirements of the public sector either directly by the accountancy profession or through other institutions. In addition as application of accounting standards may require the use of valuation and actuarial skills those professions also need to be involved in the process.
3. *Joint Development of Accounting Standards.* Another essential element is co-operation by the accountancy profession in the development of accounting standards for the public sector and to become involved in the application of those standards and the monitoring of their implementation. Without that independent involvement the effect would be that the government could be seen as setting its own accounting standards and applying them in a manner that suited the political circumstances of the moment. That would damage not only the credibility of the process but in the end would mean that the disciplines that accrual accounting and budgeting are meant to achieve could not be established. Independence of the standards adopted with a critical appraisal process, whilst uncomfortable potentially for government, is essential. However that also means that the accountancy profession must have a capacity to both understand the nature of the public sector, to recognise that circumstances are different from those of the private sector and that comment, when made, has to be made and clearly made from a politically disinterested perspective. (The work of the International Federation of Accountants Public Sector Committee can make a particular contribution to this process.)

4. *Support of the Government Auditor.* Successful implementation of accrual accounting does depend heavily upon the understanding of and willingness to support the system by the government external auditor. As accrual accounting requires not only more complex systems but also a range of new judgments (e.g. about asset values and lives, matching issues, prudence, materiality and going concern), the responsibilities and expectations of the auditor will increase and change considerably. Therefore, the external auditor should be involved in the process from the outset. That may require that the organisation, career structure and training of auditor staff should be significantly enhanced. Auditors will need a thorough understanding of accounting principles and how those principles can be maintained under the pressure of day-to-day administrative decisions. That may require the appointment to the government audit staff of qualified accountants (ideally members of a professional body), rather than relying upon the more traditional training of auditors.

5. *Comprehensive Management Training.* There exists a need for training of departmental managers to use an accrual accounting system and to achieve the benefits from its operation. There are considerable differences between the information available to managers under cash accounting system and the information available under an accrual accounting system. To make proper use of an accrual accounting system, managers need not only to understand the differences, but they also need to appreciate how they can use the accrual based information to manage activity more efficiently and effectively. Therefore, an essential component of the introduction of an accrual based system is a comprehensive management training programme for line managers. Such a training programme would need to cover the following:
 - (a) An appreciation of the basic financial concepts underlying accrual accounting: Managers will need to understand how and why an accrual accounting system is different from a cash accounting system. They will therefore need to know about the basic financial concepts that underlie accrual accounting.
 - (b) How accrual accounting allows for the introduction of improved (i.e. accrual based) budgeting and financial control systems: Managers will need also to appreciate how control will change. The focus of control with a cash based system is to ensure that cash expended in the period (or income collected) is neither greater nor less than forecast in the budget. The emphasis is therefore about 'inputs' into the activity rather than what the activity achieved, i.e. outputs. With a cash based system the main forms of management control will be on 'time', e.g. when an invoice is to be paid, and it will frequently be possible for the manager to manipulate timing in order to ensure that budgets are met. With an accrual based system this is considerably less possible and managers will not have any ability to influence time. They will therefore need to focus on resources used and the price paid for those resources. The management emphasis should therefore shift to efficiency and effectiveness and line managers will need training to not only appreciate this, but also to understand how they can make full use of accrual information.
 - (c) An understanding of the accounting information systems that are needed: Including the general ledger system, other systems needed are: a purchase order system, an accounts payable system, and an asset register.

- 6 *An appropriate cultural approach.* A public sector cultural ethic that has internalised the requirements for a neutral (i.e. non-political) civil service with a strong, well-regarded central agency, (the Ministry of Finance), responsible for the management of the government finances. There need to be well understood and accepted systems of control over departments.
- 7 *A robust audit process.* A comprehensive annual independent audit of the accounts of each department at the end of each financial year, with reports to Parliament and detailed scrutiny where appropriate.
- 8 *No corruption.* No systemic corruption and certainly no problem at all with corruption of whatever sort. Therefore, no informal parallel processes have evolved or are allowed to complement the formal processes and, consequently, rules specified about the introduction of accrual accounting and budgeting will be obeyed.
- 9 *A recognition of the elapsed time needed.* From the outset a willingness to recognise that the introduction of accrual accounting and budgeting will take time usually stretching beyond the lifetime of one Parliament and could therefore stretch beyond the period of control by one political party. The reform therefore needs widespread political support across the political spectrum.
- 10 *An IT capacity.* An IT capacity that is able to respond to the new and additional requirements that the introduction of accrual accounting, budgeting and performance measurement will introduce. The process of transition from a cash based system to and accruals based system can impose significant additional resource costs not only in terms of money but also in a demand for specialist IT skills. The scale of the change could raise questions about the overall capacity of suppliers as well as government experts, to be able to manage the change process.
- 11 *A willingness to use incentives and penalties.* The development and application of financial incentives and penalties to encourage a practical day to day management approach that looks for more efficient ways of using resources and delivering services. An example of this is a charge for the use of capital resources.
- 12 *That the accrual approach is part of a process of reform.* Another essential ingredient is that the introduction of accrual accounting and budgeting is seen as part of a process of reform and it has not been ‘parachuted’ into a stable, unchanging management process.

The significance of these preconditions will vary from country to country. For example some of the countries about to join the European Union may be in a wholly different position from, for example, most of the existing member states. Issues that will need to be considered include the strength and interests of the national accountancy profession, the state of progress on other public sector reforms whether resources exist to implement accrual accounting reform, and the degree of political consensus about the need for reform.