Governmental Accounting—A Re-examination

N.D. Gupta & Naveen Gupta

< EXECUTIVE SUMMARY >

◆The changing economic and political environment in India and the globalization in trade and services necessitates all business, commercial entities, government to follow internationally best systems/practices for preparation and presentation of financial statements. The transition from a cash based to accrual based accounting in Government and Governmental entities is underway in many parts of the world. The IFAC has shown its concern on the same by issuance of necessary guidance and standards in that regard. This article throws light on the system of budget based accounting and the need for accrual based accounting in government and its entities in India. It also deals with the implementation issues along with the possible courses of action for bringing the new system into operation.

1.0 INTRODUCTION

1.1 Government Accounting as a discipline has always been seen as distinct and separate from Commercial Accounting. This is so not only in India but in other countries also.

As long as the world economic situation permitted Governments to operate in a fully monopolistic manner, the divide between Government Accounting and Commercial Accounting did not pose either a conceptual or a practical problem. Thus, Governmental Accounting evolved in its own way based on a plethora of rules, prescribed sets of internal checks, and at the same time a fully expenses oriented system of record keeping. In the second half of the 20th century and especially in the last two decades however, the basic presumptions of Governmental Accounting have been challenged – not only in terms of its conceptual underpinnings, but also in terms of its economic relevance.

This situation which has forced many Governments to comprehensively revisit their accounting systems and procedures, has arisen more out of manifest needs for public accountability of Governmental finances. The poor countries have felt the pressure to fully account for monies that they borrowed and the rich countries have been subject to public pressure to go soft on fiscal policy and reduce the burden on the taxpayer.

Either way, it has become very necessary for all Governments to take a very hard look at the actual state of their assets and liabilities. Of course, this is difficult to do in the current Governmental Accounting System because of very basic problems in the principles of accounting which are applied.

It is for that reason that institutions of accountancy in a number of countries have concentrated their attention on Government and public sector accounting.

The authors are members of the Institute. The views expressed herein are the personal views of the authors and do not necessarily represent the views of the Institute.

The Public Sector Committee established by the International Federation of Accountants to address, on coordinated basis the needs of those involved in public sector financial reporting and accounting. The Committee issues guidance and standards in that regard with the ultimate objective of worldwide development of public sector financial management and accountability. The Committee has so far issued 20 Accounting standards for public sector accounting.

1.2 In India, the various State Governments who have a number of schemes funded by multilateral agencies under implementation, have found that they are now required to conform to the rules of presentation of financial statements as laid down by the funding agencies. These rules are invariably based on the premises of an Accrual System of Accounting. This has forced many States to at least have their program accounts kept on a Accrual basis rather than on Cash basis. Such a changeover has permitted the States to develop a greater degree of managerial control.

At the Central Government level also, similar trends are to be seen. However, the major imperative for a change in the accounting system comes not from the need to conform to funding agency description, but from the need to demonstrate transparency, greater accountability, and to obtain a fair picture of the Government's financial health.

This article examines the various issues in adopting a different accounting system for Government Accounting.

1.3 The world over, public sector accounting (mainly the government accounting) has generally been observed as cash based accounting subject to some exceptions. In India, the system of accounting followed by different kind entities is as follows:

1. Private and Public Sector Companies	Accrual based accounting under the Companies Act, 1956/ any other statute that governs the special purpose entities
2. Partnership firms and sole proprietors	Cash/ accrual/hybrid accounting. The entities which are subject to Tax Audit can not adopt hybrid system of accounting
3. National and State Governments	Generally cash based accounting
4. Local Authorities	Cash based but graduating to Accrual based accounting
5. Others	Cash/ accrual based accounting. In case of banks, insurance companies, electricity companies, they follow accrual based accounting

1.4 A single set of Accounting Standards are available for following up by all kind of entities in India. There are 28 accounting standards being followed with the exceptions to certain entities given within the standards. As may be observed above, the national/ state governments and local authorities in India generally follow cash based accounting inspite of equal nature of accountability and decision making issues attached to this particular sector. Thus, in the context of Public sector accounting, basically there are two contentious issues emerged which need to be studied further:

- The need to transform the system of cash based accounting to accrual based accounting, and
- The need to develop accounting standards to be followed in Public sector (Whether to follow the same accounting standards as are in existence or there is need of a separate set of standards in line with those issued by Public Sector committee of IFAC)

This article throws light on the first issue. The second issue will be dealt with in a separate article which will follow in the next issue.

1.5 With the changing political and economic scenario, a steep pressure has come from foreign institutional investors to implement internationally best practices for preparation and presentation of financial statements. The opening up of international barriers for trade in goods and services in WTO context also necessitated the adoption of internationally recognised system of accounting and financial reporting of transactions. Thus there is a need for serious thinking towards implementation of a new system of accounting followed in public sector. The recent corporate failures in US is another factor for more focussed attention on public accountability and transparency by improving the quality and authenticity of financial statements. Interestingly here, some people believe that the change will diminish the importance of cash and encourage government departments to use those creative accounting

devices highlighted in the recent cases of company collapses. But it is sure that these concerns are misplaced.

1.6 In the areas of banking, the Reserve Bank of India has taken number of initiatives for improvement in Accounting area. The Guidelines for Uniform accounting of Repo and reverse repo transactions between banks, the guidelines for consolidated accounting and supervision, etc. are few examples. Timely reviews are being made in view of the reformation going on in financial sector and monetary policies.

1.7 One can not get away from the fact that the introduction of new (accrual based) system of accounting in Government needs more skill and resources. The requirement of technical support and accounting staff is the key to implement a refined system of accounting. In any type of major reforms and system change it is important that all personnel involved understand the reasons for change and are capable of implementing changes and operate the new system and procedure. The strategy of addressing the gap between the capabilities of existing staff and the capabilities expected include the recruitment of qualified accountants, use of consultants, development of public sector accounting courses through professional accounting institutes/ universities and provision for training through seminars/ workshops. The Government in India has established the Institute of Chartered Accountants of India by an act of parliament in the year 1949. The institute has more than 50 years of history to produce talented Chartered Accountants in the country. The institute has a big platform for organisation of seminars and workshops throughout the country and abroad through its wide network.

1.8 Before going into some specific implementation aspects of accrual based accounting, it is important to deal with the operational aspects of budget based accounting and the benefits that we foresee under an accrual based accounting. In some of the countries, the transition process is either over or is being implemented. For example, in New Zealand, the public sector experienced a major reform in early 90's. This reform changed public sector management system based on compliance with detailed and restrictive rules and budget cash limits to a performance and accountancy based regime. In India too, the reformation is on the agenda for various state and central level governments since early 90's. Let us analyse the concept of budget based accounting prevailing in government sector in some countries:

2.0 BUDGET BASED ACCOUNTING

2.1 In budget based accounting, the management systems are dominated by centralized inputs controls, established though Treasury Instructions and the Public Service Manual, and the requirement to use centralized monopoly suppliers. Much management, and audit, effort is directed towards ensuring that these controls are understood and complied with.

2.2 All public money is required to be paid into a consolidated bank account in accordance with Treasury instructions, departments submit vouchers for payment to Treasury offices which then organize the payment, and report on the transactions in the "Public Accounts".

2.3 Budgeting is limited to a set of appropriations of cash payments for loosely defined purposes. The appropriation could be expressed in terms of the recipient, the government activity, or the type of payment (e.g., a grant or a capital payment).

2.4 International Consensus

2.4.1 In some of the countries, the national Governments have started developing a comprehensive and integrated financial management system that:

- Translates government strategy into decisions and action;
- Informs government decision making;
- Encourages the state sector to be responsive and efficient

2.4.2 As per the system introduced in New Zealand, the cabinet Ministers are formally responsible for specifying performance requirements of the chief executives of departments. Chief executive are in turn responsible for service delivery and have the necessary managerial decision-making authority delegated to them. There are incentives to perform and requirements for performance information, as a basis for monitoring and assessment. The main piece of financial legislation governing the new regime is the Public Finance Act 1989 which:

- removed many administrative controls;
- defines the appropriation process in terms of outputs;
- makes chief executives responsible for departmental financial management; and
- establishes departmental and government

reporting requirements.

2.4.3 These provisions were all designed to clarify the accountabilities of the chief executive and remove their responsibilities for things over which they have no control. In chief executives' annual performance agreements, performance is defined in a way that distinguishes between on the one hand, government's interests in the performance of a department as the purchaser of the services being provided either directly to the government or to third parties, and as the owner of the department on the other. As purchases, Ministers are looking for services that met agreed specifications as to quantity, quality, timeliness and location at the best price.

3.0 WHY ACCRUAL BASED ACCOUNTING

3.1 Accrual based accounting involves preparation of financial statements (i.e. the profit and loss statement, a balance sheet, a statement showing changes in financial position, and a cash flow statement) in accordance with the Generally Accepted Accounting Principles. In other words, an Accrual based accounting provides information on an entity's overall financial position and current stock of assets and liabilities. It helps the government in discharging its functions more effectively and demonstrate accountability to the public for the management of assets and liabilities recognised in financial statements. It would also help in making decisions about the feasibility of financing the services and planning for future funding requirements of asset maintenance, repayment/ satisfaction of existing liabilities.

3.2 As far as users are concerned, the information contained in reports prepared on an accrual basis is useful for their decision making. Financial reports prepared on an accrual basis allow the users to:

- assess the accountability for all resources the entity controls and the deployment of those resources;
- assess the performance, financial position and cash flows of the entity;
- make decisions about providing resources to, or doing business with, the entity;
- evaluate government 's ongoing ability to finance its activities and to meet its liabilities and commitments

3.3 Accrual accounting requires organizations to maintain complete records of assets and liabilities. It facilitates better management of assets, including better maintenance, more appropriate replacement policies, identification and disposal of surplus assets, and better management of risks such as loss due to theft or damage. The identification of assets and the recognition of depreciation help departmental managers to understand the impact of using fixed assets in the delivery of services, and encourage them to consider alternative ways of managing costs and delivering services.

3.4 Accrual accounting provides a consistent framework for the identification of existing liabilities, and potential or contingent liabilities. The recognition of obligation meeting the definition of a liability and the criteria for recognition:

- obligate the government to acknowledge and plan for the payment of all recognized liabilities and not just borrowings;
- provides information on the impact of existing liabilities on future resources;
- provides necessary input for government to assess whether they can continue to provide current services and the extent to which they can afford new programs and services.

3.5 Accrual accounting provides information on revenues and expenses, including the impact of transactions where cash has not yet been received or paid. Accurate information on revenues is essential for assessing the impact of taxation and other revenues on the government's fiscal position, and in assessing the need for borrowing in the long term. Information on revenues helps both users and government themselves to assess whether current revenues are sufficient to cover the costs of current programs and services.

3.6 Governments need information about expenses in order to assess their revenue requirements, the sustainability of existing programs, and the likely cost of proposed activities and services. Accrual accounting provides governments with information on the full costs of their activities so that they can;

- Consider the cost consequences of particular policy objectives and the cost of alternative mechanisms for meeting these objectives;
- Decide whether to fund the production of services within government sub-entities, or whether

to purchase goods and services directly from non-government organizations;

- Decide whether user fees should cover the costs associated with a service ; and
- Allocate responsibility for managing particular costs.

3.7 Accrual accounting can provide financial information on whether sub-entities are delivering specified services, and delivering them within agreed budgets. The same information, at a more detailed level, can also be used within sub-entities for the management of activity and program costs. Accrual accounting allows an individual entity to:

- Record the total costs, including depreciation of physical assets and amortization of intangible assets, of carrying out specific activities ;
- Recognize all employee-related costs and to com0pare the cost of various types of employment or remuneration options;
- Assess the most efficient way of producing their goods and services and of managing the resources over which they have been delegated authority;
- Determine the appropriateness of cost-recovery policies; and
- Monitor Actual Costs against budgetd costs.

3.8Accrual accounting provides comprehensive information on current cash flows and certain projected cash flows, including the cash flows associated with debtors and creditors. It can therefore lead to better cash management and may assist in the preparation of more accurate cash budgets

3.9 One of the advantages of accrual accounting systems is that activities such as commitments or purchase order systems, payroll, fixed assets, creditors and debtors are able to be integrated into one system, thereby reducing double processing and reconciliation problems associated with disparate systems. The time savings this brings about can be significant.

4.0 ISSUES IN IMPLEMENTATION OF ACCRUAL ACCOUNTING IN GOVERNMENT

4.1 Support from leaders in the public sector, both political and within the bureaucracy, is a key factor in the successful implementation of the transition to the new system. The transition to a new financial management system of a department involves:

- Specification by each department (in consultation with Treasury) of its broad classes of outputs, which would become the basis for accrual based appropriations;
- Each department developing an accrual based accounting system which would provide the basis of monthly reporting and annual reporting.
- Development of cost allocation (including where necessary time-cost) systems to enable the allocation of all departmental inputs costs to outputs. The costs allocated include overhead costs, depreciation and the capital charge;
- Developments of a system of cash management, including the opening of departmental bank accounts; and
- Departmental chief executives taking full responsibility for their financial management, including the integrity of the information they provide to Ministers and the Treasury.

4.2 There are certain accounting based implementation issues to effectively put in place the system of accrual based accounting. The major issues are listed hereunder:

4.3 Opening Balance Sheet

4.3.1 A major concern through the implementation is to ensure that the opening balance sheets are as complete and accurate as possible. The best starting point may be to carry out a stocktaking and certify that the resulting list comprised all the assets under their control. This is an area in which the auditors are particularly helpful and constructive in assisting departments to put together auditable records and processes.

4.3.2 Department and auditors may find it a particularly difficult task to ensure that all properties are reported, and to do so it becomes necessary to co-ordinate searches of Government Valuation records with the Land Transfer Offices and individual departments.

4.4 Cost Allocation

4.4.1 A necessary requirement of focusing the financial management systems on outputs is to build cost accounting systems, which allocate costs to outputs. The departments will try to identify the unit

costs both for internal comparison purposes and for benchmarking with other organisations. The professional accountants may again be helpful in developing appropriate cost accounting systems.

4.5 Production of a new series of GAAP based financial statements of the Governments

This issue has the following key elements:

4.5.1 **Development of Accounting policies:** In most areas, the same approach that the private sector takes could be used without difficulty. This approach however did not mean that there are not a number of contentious issues to be dealt with. The topics on which accounting policies or disclosure statements are required regarding assumptions used in the preparation of the financial statements, are listed below:

- General (Reporting Period, Going concern Assumption, Measurement Basis, etc.,)
- Assets(Definition and recognition of assets, intangible assets, investments etc.
- Liabilities (Pension liabilities, lease liabilities, bonds/stocks, etc,)
- Revenues (Basis for recognition, donations,. Lease revenue etc.,)
- Expenses (Depreciation , Amortization, income tax , etc.,)
- Equity/Net worth (Accumulated surplus, foreign currency reserve, assets revaluation reserve etc.
- Other policies(extraordinary items contingent assets./liability, related party disclosures etc.,

The list of policies shown is not necessarily comprehensive, the specific policies may be based on local public sector accounting standards, if any, and in the absence thereof on any other authoritative sources of guidance adopted by the entity. The types of policies required would vary depending upon the type of entity. Accounting policies would need to be subject to periodic review in order to ensure that they are consistent with authoritative accounting standards and generally accepted accounting practice over time. The accounting professionals can play a major role in identification of accounting policies for public sector based on the guidance available. The guidance may be developed at regulatory level and be implemented

through statutes for ensuring effective compliance.

4.5.2 **Reporting entity issues:** A critical issue in determining the accounting policies is establishing the reporting entity. The public sector entity may be defined through a definition under the statute. Determining the boundary of reporting entity involves the review of existing reporting entities and identification of controlled entities.

4.5.3 **Asset Valuations :** The government and its entities may hold financial, physical and intangible assets. One of the legacies of the previous cash accounting system may be the unavailability of information on the historic cost of many assets. This may be resolved by using, say, a net current value approach to the valuation of assets. For example, where a net realizable value cannot be obtained or is otherwise inappropriate, as in the case of some infrastructure and " heritage type" assets, a depreciated replacement cost concept may be used. The need therefore is to issue necessary guidance in that regard and the mindset of government and departments to transform.

Examples of the general asset related issues:

- Compilation of an asset register.
- Determining the category of assets.
- Compilation of accurate opening balances
- Establishing system to support ongoing requirements of accrual accounting
- Financial statement disclosures

If we take the case of inventories , the issues could be the stock taking, assignment of cost, adoption of method of inventory valuation, implementation of system of control over inventory, etc,.

4.5.4 **Power of tax:** The power of tax and other regulatory rights are a feature of governments distinguishing them from the private sector. Whether the power to tax should be reported as an asset in the financial statements, need to be studied. On the face of it, the criteria for recognizing an asset does not seem to be properly satisfied, as the transaction or event giving rise to the benefit has not occurred (e.g. earning of taxable income), nor could its value be measured reliably. The power to tax may be viewed as analogous to the powers that mutual or cooperative organizations have to levy their members. This is not treated as an asset as members want to know the financial position of the organization prior to the exercise of the power to levy. Further, it is impossible to value the power to tax as "asset" with sufficient reliability and the attempt to do so would overwhelm the other information in the balance sheet. Non-recognition of the power to tax and welfare entitlements in the balance sheet does not imply that information on these powers and obligations is not important in determining the financial condition of a government. Suitable disclosures in this regard may be recommended.

4.6 In addition to these the issues like valuation of liabilities, recognition of revenues and expenses, disclosure of contingent liabilities, etc. are also involved. But the solution is not out of reach of the beneficiaries and / or the regulators.

CONCLUSION

5.1 Finally, there seems to be no fundamental theoretical barrier of a democratic government which prevents the implementation of accrual accounting. Rather, there is much to recommend the development of accrual accounting in government.

5.2 Accounting is important and exciting when it generates information that is used by decision makers. Conversely, without decision makers demanding and using accrual information, the implementation effort is far less likely to succeed. While the demand for accrual accounting information is likely to increase as public administration trends towards public management, development of accrual information should be seen as an integral element of this reforms and not a stand alone exercise.

5.3 Commitment is critical. This requires a clear understanding that accrual accounting will not bring benefits as of itself but rather by providing richer information can bring benefits by improving the quality of decisions. The lesson is that commitment based on false expectations will not continue.

5.4 The net fiscal costs of operationalizing accrual accounting systems compared with cash systems are relatively trivial. Overly centralized accounting processes, with subsidiary elements that are more or less poorly integrated are surprisingly cumbersome and expensive when compared with the best private sector practices of centralized cash management, with streamlined financial management systems. ■