Preconditions for Successful Implementation of Accrual Accounting in Central Government

Noel Hepworth

A number of national governments, including the UK, have successfully implemented a change to accrual accounting. But the change should not be regarded as an end in itself: it will not solve the problems that arise where inadequate cash accounting systems exist; it will not improve control or management where inadequate control and poor management exist; nor will it improve external audit or the legislature's control over the executive. Before this reform is introduced, cash accounting should be robust, control should be secure, external audit should be functioning well and the legislature should have an ability to call the executive to account. This article sets out preconditions that governments need to meet to ensure that the full benefits of accrual accounting are achieved.

One purpose of this article is to urge caution on those who are contemplating or encouraging the change to accrual accounting in central government, unless the conditions are absolutely right. Another is to set out the preconditions that ought to be met so that the benefits of accrual accounting, which can be substantial, can be achieved. Accrual accounting (which requires that income and expenditure are recognized as they are earned or incurred, not as with a cash basis of accounting, when they are received or paid) will not solve underlying financial control problems—it can only make them worse. This is because it leaves considerable scope for judgement and if financial control is not effective under a cash accounting system, then it is likely to be even less effective under an accrual-based system.

Multilateral institutions, such as the International Monetary Fund (IMF) and the World Bank, are encouraging governments to introduce accrual accounting and much work to facilitate this is being undertaken by the international accountancy profession, with the support of these multilateral institutions. However, they also recognize the problems that some governments have and are equally keen to see the development of a robust cash accounting standard.

A number of governments have successfully implemented the change to accrual accounting and published much information about the process, problems and results of the change (for example New Zealand, Sweden and the United Kingdom). Other governments have said that they are accounting on an accrual basis, but without the same degree of publicly available information (for example Croatia) and yet others have said that they are considering the change and are engaging in extensive research before they do so (for example Norway and The Netherlands). Some countries with developing or transition economies (for example Croatia) claim either to have already adopted the system, or to be moving to adopt the system with the encouragement of the multilateral institutions (and also, perhaps, by some consultants with an eye to lucrative future contracts).

There is an element of following fashion, as with all management techniques, in the motivation for the change in some countries. In other countries, an ability to complete the current IMF Government Finance Statistics (GFS) returns appears to be taken to mean that the government has adopted accrual accounting. However, it is quite possible to complete these accrual-based returns by means of adjustments, which provide useful information, but which are much less complex than a system of accrual accounting

There are risks with the switch from cash to accrual accounting, and the costs and benefits of the change are not necessarily well understood. Nor is such a change necessarily a priority. At worst, to change can mean an enormous wasted investment and a risk of losing financial control and/or the further

Noel Hepworth OBE is Chairman of CIPFA International, and a former Director of CIPFA. He is also Chairman of the Public Sector Committee of the Fédération des Experts Comptables Européens and, until 1999, was the UK technical adviser to the IFAC Public Sector Committee.

extension of central control in order to ensure that the government's ministry or department of finance does not lose its ability to manage public expenditure.

What does need to be understood is that there is not yet available a complete body of public sector accrual accounting standards and, for some of the key standards that do exist, sophisticated judgements need to be made about the interpretation and application of those standards. The Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) is developing a set of public sector standards with the support of the IMF, the World Bank, the Asian Development Bank and others (see Sutcliffe, 2003). So far, the PSC has largely produced a core set of standards based on private sector standards and is now starting to address issues which are specific to the public sector. At the time of writing (December 2002), decisions still have to be made about accounting policies towards such issues as taxation, military assets, heritage assets, universal health-care programmes, social insurance and public pensions programmes.

There appears to be a considerable misunderstanding of accrual accounting in some countries, and the risk for those who are in the vanguard of the change, such as the international accountancy profession and the multilateral lending institutions, is that the failure to understand what is required may damage the whole process. The result may be that the gains that can be available will be lost, or significantly delayed, while the damage is put right. Even in developed countries with a sophisticated understanding of accounting, there remains ever-present the risk that governments will seek to modify standards in order to suit their own political objectives. Possible examples of this relate to the treatment of long-term liabilities, such as pension costs, and off-balance sheet transactions. Governments have political incentives to present information and costs in the most attractive manner and, in this sense, they can be compared to the boards of companies similarly wishing to present their financial results in the most attractive manner. The lessons of recent events in the private sector (WorldCom and Enron for example) ought to motivate those with an interest in the public sector to ensure that such incidents will not be replicated.

The Need for Culture Change

Accrual accounting should be regarded as being about much more than financial reporting. Accrual accounting is about the whole process of financial management. It is partly about obtaining a better understanding of the nature of 'costs', but it is also about a better understanding of what those costs mean for the financial management of government and the outcomes that government is trying to achieve. The main criticism of cash accounting is that cash accounts can be (and are) manipulated to ensure certain cash outcomes are achieved. Exactly the same criticism can be levelled at accrual accounting, which offers even greater scope for manipulation.

The introduction of accrual accounting should not be seen as a technical accounting change, and to focus on financial reporting only is a mistake. Politicians and stakeholders rarely interest themselves in what has happened; what they are really interested in is 'what will happen'. Immediately, a question is raised about the budget. If the accounts are to be maintained on an accrual basis, why not also the most important financial document of all, the budget? Without that, there can be no easy comparison between actual and budgeted inputs. In addition, without accrual information, it is difficult, if not impossible, to compare the resource inputs (as reflected by the resources consumed) and the outputs, in terms of service delivery, in a meaningful way. Accrual accounting therefore leads to pressures for accrual budgeting which, while possibly justified in some countries with very highly developed systems, brings serious further challenges of its own.

Accrual accounting also raises difficult issues for both political and official managers. It defines costs in a wholly different way. It requires assets to be valued and it raises questions about efficiency in the use of assets. It raises questions about comparisons, particularly with private sector providers of services. Included in these questions are those about the comparative costs of capital in the private and public sectors and, for some activities, the process and cost of risk transfer to the private sector.

Are these questions to be ignored? If they are to be ignored, what is the point of the costly and risky exercise in the first place? If not, how will they be acted upon? If they are to be acted upon, what is required is a change in the whole management culture. Although considerations other than cost need to be considered, particularly regarding qualitative factors (of which there can be many), it may be that assets that are not being properly utilized should be disposed of. If a service or activity can be provided more cost-effectively by the private sector, then perhaps it should be. If service delivery arrangements could be changed to substitute capital for revenue, then this should be considered. The point is that these types of issues should be properly considered and not ignored.

In the private sector the usual requirement is that, under accounting standards, assets are valued on an historical cost basis. There is no clear agreement about the basis of valuation to be used in the public sector. Some countries have chosen to use historical costs (for example Sweden) and others have chosen to use current values (for example the UK). The argument often hinges around practicalities and the purposes of valuation.

However, there is a point of principle that should be addressed, and that is that all other public sector service delivery costs are current costs and there is no logic in arguing that one cost should be treated differently. Capital assets should be valued and revalued to ensure that the service costs reflect the current cost of those assets and, as those assets wear out over time, they should be depreciated, with an appropriate depreciation charge being included in the service delivery costs. If there is a maintenance failure, and the asset deteriorates more rapidly as a consequence, then depreciation should be increased. In other words, the failure of governments to spend on maintenance should not be an apparently costless decision because the true costs accrue to future generations. The cost should fall on the present generation responsible for the maintenance failure through a higher depreciation charge; this can only be identified if current values are used.

In addition, the cost of the asset is more than the capital cost. There is also the 'interest' charge, or cost of the capital employed to hold that asset. Derivation of this charge raises complex issues, and practice varies across countries. For example, New Zealand uses a range of rates, applied to historical valuations, whereas the UK uses a single rate, applied to current valuations. Depreciation and the cost of capital together constitute an annual charge which has no equivalent in cash accounts. Public sector capital assets are no longer 'free goods'. The need to be able to respond to this information illustrates the culture change that should accompany a change to accrual accounting. Unless this is understood and accepted, the question is again raised about whether or not the change to accrual accounting should be made.

What this means is that the change to accrual accounting should be a part of the process of reform in the delivery of public services. Therefore, if a country has a policy of not changing public employees' terms and conditions of service, or of not transferring services to the private sector or of not disposing of public assets, on ideological grounds, then this limits the benefits of switching to accrual accounting. There are other benefits to accrual accounting, such as a more accurate statement of the costs of resources consumed, but unless there is a political or managerial willingness to follow up the better information that flows from its adoption with other reforms to the process of public sector management, there is little point in the advocates of a switch to accrual accounting pressing their case. Accrual accounting is not an end in itself.

There is also a wider practical issue. While accrual accounts can provide a better quality of financial information, there needs to be the ability and expertise in the country to identify and debate the implications of that better quality of financial information. Unless that exists, there is unlikely to be the ability and expertise available to ensure both that accrual accounting is properly implemented and that the results are not manipulated for the benefit of the government of the day. If that ability and expertise do not exist, accrual-based financial statements may add to distrust of government, the very opposite of the objective which accrual accounting is trying to serve.

The problem of expertise is not just an issue for the executive. The legislature also has to accept the need for change and a critical question is whether the legislature has the capacity to maintain adequate control over the executive should a change be made to accrual accounting. That change ought to affect the approach to the budget as well as to the financial accounts. The legislature therefore needs to understand the implications of the change and to have the technical capacity to test the proposals of the executive.

Attitudes to Control

In theory, public sector managers in ministries that deliver services are responsible for establishing the internal financial control framework. They may do so in accordance with a specification laid down by a central ministry, such as a ministry of finance. That central ministry should not itself undertake the internal control function.

However, the reality is that the traditional approach in many countries (especially in developing countries and countries in transition) is for the ministry of finance not to trust these 'line' ministries for fear of losing financial control, or because it is concerned about the integrity of the administrative processes (perhaps as a response to high levels of fraud or corruption). It therefore seeks to 'control', in one way or another, the management and/or activities of the line organizations. There is a focus on detail, with a concern for individual transactions rather than systems. Moreover, there is a lack of management information available to line management because all information is held by the ministry of finance. This weakens the ability of line management to manage, thereby seeming to confirm to the centre that the line ministry does not have a sufficient management capability. This reinforces the argument for central control. The predictable consequences are that:

- Control is tight over individual transactions, but lacks a perception of the objectives that those transactions are aimed at achieving.
- The central resources are devoted disproportionately to bureaucratic procedures, and procedure is a dominant concern.
- Distrust is enhanced because of the need to ensure compliance with procedures and, where failures are discovered, the usual response is to add further rules, adding to the bureaucracy.
- Line management is unable or unwilling to take the 'control' responsibility.
- Serious omissions exist, particularly in reviewing the adequacy of systems.
- There is a lack of emphasis on value-for-money review.
- No understanding exists of the concept of 'materiality', which means that judgements are not made on the basis of their relative significance to the organization.

Should an attempt be made to introduce accrual accounting with such attitudes to control?Accrual accounting in these circumstances will almost inevitably result in a substantial addition to central control. If the ministry of finance is not prepared to allow managerial freedom with a cash accounting system then, given the judgements that are associated with accrual accounting, there is little prospect of it ceding the freedom needed by line ministries to benefit from the extra information provided by accrual accounts.

Who Should Set Public Sector Accounting Standards?

Most countries that have adopted accrual accounting have based their definitions of accrual accounting upon the accounting standards applying in their country to the private sector, supplemented where appropriate to take account of the public sector context. In doing the latter, they have generally taken into account the specific public sector standards being developed by the PSC. However, international accounting standards do not apply in all countries and, even where they do, private sector standards do not cover the particular circumstances of the public sector.

Accounting Rules

Traditionally, the ministry of finance has set the accounting rules that apply in the government of a particular country. The assumption therefore is likely to be that the ministry of finance would expect to set the accrual accounting standards. However, setting accrual standards is a very different matter from setting the rules about cash accounting. What is more, the scope for interpretation, indeed manipulation, of accrual accounting standards is considerable and can result in different financial results and different taxable results for those government entities that pay tax, depending upon the interpretation that is permitted. And there is also the issue of consistency where difficult decisions are required.

If the ministry of finance is to set the standards, and given that most such ministries have little contact with the accountancy profession and employ few accountants, there may be difficulties in acquiring the necessary expertise to make the judgements that are required in order to apply accrual accounting standards.

The introduction of accrual accounting is a dynamic process driven by a number of factors, such as:

- International accounting standards are constantly being developed through the issue of new statements of practice and modifications to existing practice.
- Practical experience of operating accrual accounting will require modifications to be introduced.
- Developments in government activity will also require that changes be made.

Therefore, the ministry of finance, the external auditor and the legislature will each need to have the capacity to recognize the need for change, the technical ability to respond to change, and the operational capacity to introduce changes as they emerge. This means that a system of regular updates has to be available. Such updates require a systematic discussion process, with the standards being published to ensure that the whole process is transparent and therefore properly documented so that it can be understood.

Before accrual accounting is introduced, the capacity of the ministry of finance to understand and implement accounting standards needs to be established. However, whether the ministry should also be responsible for the setting of those standards is another question. Transparency is a critical issue. If there is a general lack of transparency, that should be a factor influencing the decision about whether or not to adopt accrual accounting.

Control over the accounting standards that are used, and the interpretation of those standards, is key. Governments claim that they are sovereign and that they alone should have the power to set public sector accounting standards. In practice, in many of the countries that have adopted accrual accounting, the ministry of finance has not had unfettered discretion to set accounting standards. While there may be a considerable degree of independence, usually the national accountancy profession is involved in the process.

Governments (and those encouraging them) wishing to adopt accrual accounting should consider whether:

- There is the capacity to adapt private sector accrual accounting standards.
- A sufficient body of such standards is available, albeit supplemented by the work of the IFAC PSC.
- A capacity exists to develop standards to fill the gaps and to maintain a dynamic process of development.
- An independent element can be introduced into the standard-setting process, with a sufficiently rigorous independent scrutiny by the legislature to ensure that accounting standards are not manipulated and that the process of standard setting is transparent.

If these characteristics do not exist or cannot be developed, there is little scope for the introduction of accrual accounting in a manner that will ensure, as far as is reasonably possible, that decisions about accrual accounting will be made dispassionately. Therefore, introducing accrual accounting in such circumstances will add to risk and could well result in a failure to achieve the gains sought from its introduction.

External Audit

A crucial supporter of any proposed change to accrual accounting needs to be the external auditor. In many countries, the external auditor has an overwhelming concern for the legality of expenditure and due process in the making of expenditure decisions. Usually with this approach, there is relatively little audit activity directed at value for money and the main audit emphasis is upon compliance with the budget, which is often very detailed and may itself be a part of the law. The auditor does not approach the audit from a financial point of view—the audit certificate is principally about compliance rather than about wider financial issues.

The culture change referred to above applies as much to the external auditor as to the civil service. The external auditor not only needs to be involved in the process of change, but also should have the understanding and ability to assess the impact of the change to accrual accounting upon the management approach—not least to value for money.

The external auditor will also need to have the capacity to make judgements about the appropriateness of the interpretation of accounting standards and particularly over the consistency of application of those standards. This is particularly important where the application of the standards may cause the government financial embarrassment. The auditor provides the check on management abuse of accounting standards.

Without the active support and understanding of the external auditor, the introduction of accrual accounting will be flawed, and power will shift to the ministry of finance. Either the counter-balance provided by the auditor will not exist, or the continued audit focus on legality and procedure will make it much more difficult for the potential management gains from accrual accounting to be realized. These risks are particularly great where control is highly centralized.

Therefore those interested in pursuing accrual accounting should have regard to the capacity of the external auditor and the willingness of the auditor to change the audit mandate. If there is not the interest or the capacity to change, that should raise serious doubts about whether the exercise is appropriate.

Preconditions for Success in Introducing Accrual Accounting

A characteristic of many reforms is that they are introduced into an organization with neither the willingness culturally to accept the reform, nor the technical ability to understand and implement the reform—or, indeed, to maintain it once introduced. As a result, the reforms either do not succeed or they create distortions that have damaging effects and, in either event, are eventually abandoned or put to one side as other new ideas or fashions emerge.

On the basis of the preceding discussion, the following seem to be the preconditions for success in the introduction of accrual accounting in government:

- Consultation and acceptance are indispensable to the introduction of accrual accounting, without them there will be neither understanding nor acceptance. There is no point in a ministry of finance 'command-and-control' type of approach. To be successful, the organization needs to be prepared culturally for its introduction, and it must be willing to recognize and accept the benefits that the changes will bring about and the costs of implementation in their widest sense. There also has to be 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.
- The accountancy profession must have the capacity and be 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 an increase in the number of financial managers (who may be qualified accountants) employed by government and 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.
- 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 would be seen as setting its own accounting standards and applying them in a manner that suited the political circumstances of the moment. That would not only damage 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 through a critical appraisal process, while potentially uncomfortable for government, is essential. However, this also means that the accountancy profession must have a capacity to both understand the nature of the public sector and to recognize that circumstances are different from those in the private sector; comment, when made, has to be clearly made from a politically disinterested perspective. Equally, the public sector needs to have the capacity and capability to influence the public sector standard setters.
- Successful implementation of accrual accounting depends heavily upon the understanding of, and willingness to support, the system by the external auditor of central government. As accrual accounting requires not only more complex systems, but also a range of new judgements (for example about asset values and lives, matching issues, prudence, materiality and going concern), the responsibilities and expectations of the auditor will change considerably. Therefore, the external auditor should be involved in the process from the outset. That may require that the organization, career structure and training of auditors should be significantly changed as well as the audit approach and mandate. 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 of qualified accountants to the staff of the central government auditor, rather than relying upon the more traditional training of auditors.
- A comprehensive management-training programme for line managers in how to use an accrual accounting system is essential, so they can derive benefits from its operation. There are considerable differences between the information available to managers under

cash accounting and the information available under accrual accounting. To make proper use of an accrual accounting system, managers not only need to understand the differences, but also need to appreciate how they can use the accrual-based information to manage activity more efficiently and effectively.

- There must be a public sector cultural ethic that has internalized 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 government finances. There need to be well-understood and accepted systems of budgetary control over departments, coupled with a willingness to promote line ministry control and the management flexibility that that requires.
- A comprehensive, annual independent audit of the accounts of each government ministry or department is essential at the end of each financial year, with reports to the legislature and detailed scrutiny where appropriate.
- There must be no systemic corruption, and no informal parallel processes that are allowed to complement the formal processes should exist. The prevailing culture should ensure that rules specified about the introduction of accrual accounting and budgeting will be obeyed.
- From the outset, there must be a willingness to recognize that the introduction of accrual accounting and budgeting will take time—usually stretching beyond the lifetime of one legislative term and potentially beyond the period of office of one political party. The reform therefore needs widespread support across the political spectrum.
- There must be an IT capacity that is able to respond to the new and additional requirements that the introduction of accrual accounting and budgeting will introduce (for example charging for the cost of capital).
- There must be the capacity to develop and apply 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.
- The introduction of accrual accounting and budgeting should be seen as part of a wide-ranging process of reform, and it has not 'parachuted' into a stable, unchanging management process.

Conclusion

The introduction of accrual accounting should not be regarded as an end in itself. Financial reporting is not the only issue. For accrual accounting to be successfully introduced a whole series of preconditions need to exist. The advocates of accrual accounting should recognize the significance of these conditions, for, without their existence, the risks from this reform are likely to be substantial. Accrual accounting will not solve the problems that arise where inadequate cash accounting systems exist. It will not improve control or management where inadequate control and poor management exist. Indeed it will make things worse. It will not improve external audit or the legislature's control of the executive.

Before the reform is introduced cash accounting should be robust, control should be secure, external audit should be functioning well and the legislature should have an ability to call the executive to account. To pay too much attention to the technicalities of accrual accounting standards without having regard to the operational environment into which accrual accounting is to be introduced would be a serious policy mistake. ■

References

Likierman, A. (2003), Planning and controlling UK public expenditure on a resource basis. *Public Money & Management, 23*, 1, pp. 45–50.

Sutcliffe, P. (2003), The standards programme of IFAC's Public Sector Committee. *Public Money & Management, 23*, 1, pp. 29–36.

Notes for Authors

Public Money & Management: Integrating Research with Policy and Practice has a multidisciplinary and international audience. It particularly favours articles which contribute new knowledge as a basis for policy or management improvements, or which reflect on evidence from public service management and finance in order to suggest topics for research. Readers include: officials in all types of public service organizations; academics; consultants and advisers working with the public services; politicians; journalists; and students on both academic and professional courses. It is essential that articles are easily understood by all these people. Authors should therefore avoid unnecessary jargon and explain technical terms.

The journal publishes Core articles, New Developments and Viewpoints. *Core* articles are about 5,000 words long. They are carefully refereed and are expected to meet high standards of intellectual argument or understanding in the practice in public management. Core articles can be freely submitted. *New Developments* articles focus on the evolution of contemporary public service policy, management or practice. The editors welcome them from anyone with an interesting and topical subject to offer, so long as it is written about in an accessible way. These articles are not normally refereed, but are subject to editorial scrutiny and the advice of the editorial executive, as required. Length is typically 2,500 words, with an emphasis on conveying the impact of change in a detached, informed and authoritative way. *Viewpoints,* about 1,000 words long, are personal statements about topical issues: they should put forward an argument and make a case, supported by examples or evidence.

Submission

Manuscripts should be sent to Michaela Lavender, c/o Sandra Harper: *Public Money & Management*, CIPFA, 3 Robert Street, London WC2N 6RL. Five copies of each article should be submitted.

Preparation

The manuscript should be typed in double spacing on one side of an A4 sheet. The following items should be included: title page, including full addresses of all authors; a two-line biography about each author; and a summary of around 100 words (core and development articles only). Tables and figures should be submitted on separate sheets. Figures should be in a form suitable for use as camera-ready copy. Spelling should follow the *Oxford English Dictionary* (Oxford University Press). Headings of no more than two grades should be used and these should be typed on separate lines.

The journal uses the Harvard (name, date) system of referencing; references in the text should be given as (Brown, 1990), or Brown and Jones (1990), or Brown *et al.* (1992) if there are more than three authors. References should be given at the end of the article in a single alphabetical list:

To a journal: Stoker, G. (1996), The struggle to reform local government: 1970–95. *Public Money & Management, 16,* 1, pp. 17–22.

To a book: Margetts, H. (1996), Information technology in government. In Jackson, P. and Lavender, M. (Eds), *The Public Services Yearbook, 1997/98* (Pitman Publishing, London).

Final Manuscripts and Proofing

After acceptance, authors are requested to submit their manuscripts by email (preferably in Microsoft Word) to the Managing Editor, Michaela Lavender: MickyLavender@aol.com. Proofs for checking in PDF (Acrobat) format will be sent to authors by email. Proofs should be returned promptly by fax to Michaela Lavender on (001) 561 218 8673.

Copyright

Authors are requested, upon acceptance of their article, to transfer their copyright to CIPFA. This ensures that requests for permission to reproduce articles are handled systematically and in accordance with a general policy which is aware of the market and any relevant changes in international copyright legislation.