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Accrual accounting in the Public Sector

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AT THE HEART OF
PUBLIC SERVICES

Accrual accounting in the Public Sector

Most Governments budget and account for income and expenditure on a cash basis.

Pressure now is to switch to an accruals basis for the accounting. (EC is switching.)

Is this good or bad and are all EU governments expected to follow?

Remember – greater risk of manipulation with accrual accounting than with cash!

Accrual accounting in the Public Sector

- What are financial reports for?
- Are financial reports ‘the whole truth’
- Is there an ‘Enron’ type risk in the public sector?
- Does the system of accounting make any difference?
- If there is a risk, what can be done?

Financial Reporting in the Public Sector IPF – ‘the whole truth’?

What are the purposes of the annual accounts?

- To inform the IMF/Eurostat?
- To keep a record of stewardship –if so, to whom?
- To indicate efficiency in use of resources?
- To inform stakeholders and taxpayers?
- To provide a summary of transactions?

Whatever the purpose how do you ensure the purpose is achieved?

Financial Reporting in the Public Sector IPF

– ‘the whole truth’?

Are the accounts complete?

- What about ‘off –balance sheet transactions’?
- Are all public sector entities included?
- Are all transfers, guarantees, other obligations?
- What about pension liabilities for civil servants?
- Are all assets and liabilities included; what value?
- What happens to uncollected tax revenues?
- Anything else?

Financial Reporting in the Public Sector

– Is an Enron possible? (1)

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What about the public sector in your country? Why?

- The accounts are not complete
- Accounting is on a cash basis
- Budget is the focus of interest, not the accounts
- The overall concern is with inputs, not outputs
- Distinction between capital and revenue lacks clarity

Financial Reporting in the Public Sector IPF

– Is an Enron possible? (2)

- Audit and scrutiny process is inadequate
- Published accounts are not understandable and no clear user of financial statements
- Rating agencies do not understand public sector accounts
- Political desire is to present the best position

Issue of financial instability in accounting terms is never raised – issue always addressed in economic terms

Financial Reporting in the Public Sector IPF

– Is an Enron possible? (3)

In private sector Enron led directly to new controls:

- New responsibilities on chief executives
- A review of accounting/audit standards
- New controls over external auditors with clearer separation of activities to secure independence
- Strengthening of the supervisory arrangements on both auditors and companies

What about the public sector? Governments claim
'sovereignty'

What can be done to stop an Enron type situation emerging in the public sector?

- Is it the form of the accounting system that creates the risk in government accounting?
- Would a change from cash to accruals make the difference?

No – Enron accounted on an accruals basis!

Other factors are far more important

What factors might prevent or reduce the IPF risk of an Enron in the public sector? (1)

- Strong audit/accountability arrangements
- Clear separation of capital from revenue expenditure and income
- ‘Risk’ has to be genuinely transferred to the private sector before items can be removed from public sector
- Therefore devices like ‘leasing’ and private sector finance of public assets need to be carefully assessed for their impact



What factors might prevent or reduce the risk of an Enron in the public sector? (2) ^{IPF}

- Political willingness to challenge and cause change in accounts if necessary
- Independence of standard setting from Government
- Independent accountability of civil service
- A constitutional requirement that future commitments are fully accounted for, including leases/guarantees/pension/social obligations

Factors that might prevent or reduce the risk of an Enron in the public sector

Is all this feasible? If not what can be done to reduce the risk or is it inherent in the system?

What about international controls? If so who should police their application and what should be the sanctions?

Maastricht Treaty type sanctions for failure to meet economic targets e.g. Greece?

Benefits and risks of cash accounting

Benefits:

- Simple
- Links with cash budget and taxation systems
- Easy to understand
- Easy to audit and control

Benefits and risks of cash accounting

Risks:

- Ability to manipulate cash flows
- Assets and liabilities ignored
- Cash statement does not provide a full picture of the financial position
- Does not facilitate efficiency in use of resources
- No link with economic analyses

Moving to accrual accounting

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Weaknesses of cash accounting have led some European Governments to adopt accrual accounting:

Finland, Iceland, Sweden*, United Kingdom*, European Commission * and accrual budgeting

Others are considering it:

Norway, France, Croatia, German local government

A limited list – who else?

But most countries can complete the GFS – doesn't that mean they are using accrual accounting?



What is the purpose of accrual accounting?

Is it:

1. To improve the quality of financial reporting and if so, to whom? The IMF, Eurostat? Who else?
2. To improve the quality of financial management of government as a whole?
3. To improve the quality of financial management of individual services and cost centres?

Does it do any or all of these on its own, who is interested and what actions are taken as a result?

Benefits and risks of accrual accounting

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Benefits:

- Accrual accounts more complete than cash
- Scope for manipulation of cash removed
- Facilitates better quality management
- Forces full record of assets and their use
- Provides opportunity to change organisational behaviour – incentives/penalties
- Provides better assessment of financial health and can link with economic data



Benefits and risks of accrual accounting

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Risks:

- Seen as a technocratic exercise, not management driven
- Lack of adequate accounting standards
- Standards capable of manipulation
- No linkage with budget (unless reformed) and therefore risk of loss of financial control
- Politicians will not impose discipline e.g. cost of capital
- Management unwilling or unable to use accrual information to improve services



Comparison of risks – cash v accrual

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Accruals creates illusion of a quality system, but the reality is that quality depends upon:

- Independence of the standard setting process
- The skills of government accountants
- Management capacity to use the information
- Political willingness to address issues
- Quality of audit and reporting process
- Use of reports by politicians and stakeholders



An accruals system – pre –conditions (1)

Preconditions for the success of accruals?

- Politicians/management understand the change and how information can be used to improve efficiency
- Accounting standards are set independently of government, or jointly with third parties
- The accountancy profession is willing/able to co-operate with the civil service, to train accountants in government and to educate staff in an understanding of the standards

An accruals system – pre –conditions (2)

- Government auditor supports/participates in the reform
- Comprehensive management training programme to focus on resources used rather than cash paid
- The budget is prepared on same accruals basis
- An IT capacity exists to manage the information promptly and efficiently
- Managers can/will use results to improve efficiency
- Politicians will make the resulting decisions

Comparison of cash and accrual summary

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On balance, unless accruals system is used effectively and the right conditions exist, the greater risk of loss of financial control lies with an accruals system than with a cash based system.

To change, takes time (not least political/management education) and is costly.

Do not make the change unless prepared to carry through the political/management consequences.

‘Rewards are great: risks are high!’



Are European Community members expected to adopt accrual accounting?

No!

The EU regulation about accrual accounting affects only the European Commission itself.

Nevertheless, European member states do have to conform to stricter public financial control standards and accrual accounting may be part of that for some countries.

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